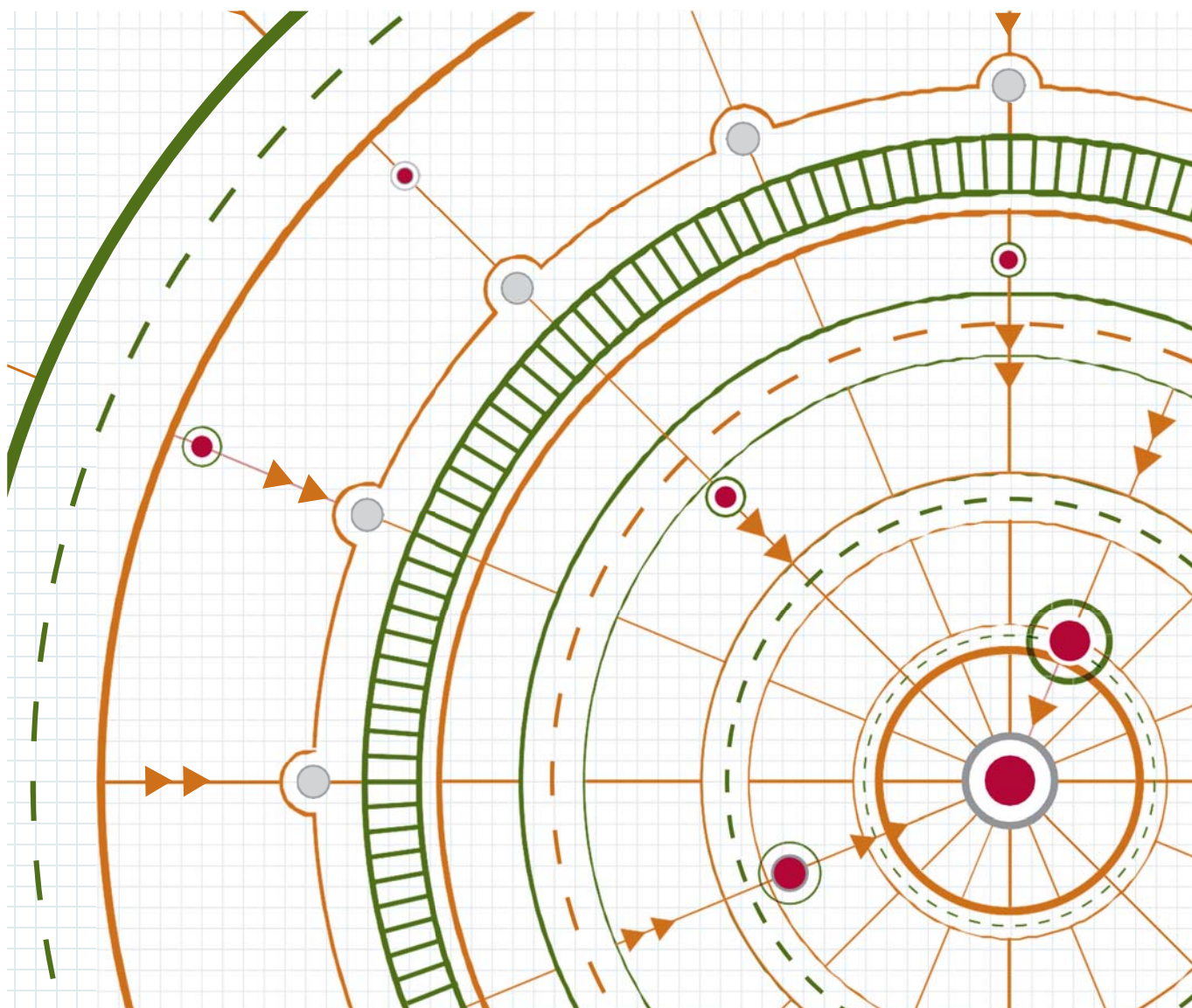


Module 11—Basic Financial Instruments



IFRS[®] Foundation

Supporting Material

for the *IFRS for SMEs*[®] Standard

including the full text of
Section 11 *Basic Financial Instruments*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions and case studies

IFRS[®] Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Telephone: +44 (0)20 7246 6410
Email: info@ifrs.org
Web: www.ifrs.org

Publications Department
Telephone: +44 (0)20 7332 2730
Email: publications@ifrs.org

This module has been prepared by IFRS Foundation (Foundation) education staff. It has not been approved by the International Accounting Standards Board (Board). The module is designed to assist users of the *IFRS for SMEs*[®] Standard (Standard) to implement and consistently apply the Standard.

All rights, including copyright, in the content of this publication are owned by the IFRS[®] Foundation.

Copyright © 2018 IFRS Foundation. All rights reserved.

Email: info@ifrs.org Web: www.ifrs.org

Disclaimer: All implied warranties, including but not limited to the implied warranties of satisfactory quality, fitness for a particular purpose, non-infringement and accuracy, are excluded to the extent that they may be excluded as a matter of law. To the extent permitted by applicable law, the Board and the Foundation expressly disclaim all liability howsoever arising whether in contract, tort or otherwise (including, but not limited to, liability for any negligent act or omissions) to any person in respect of any claims or losses of any nature, arising directly or indirectly from: (i) anything done or the consequences of anything done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents of this publication; and (ii) the use of any data or materials contained in this publication or otherwise. To the extent permitted by applicable law, the Board, the Foundation, the authors and the publishers shall not be liable for any loss or damage of any kind arising from use of and/or reliance on the contents of this publication or any translation thereof, including but not limited to direct, indirect, incidental or consequential loss, punitive damages, penalties or costs.

Information contained in this publication does not constitute advice and should not be used as a basis for making decisions or treated as a substitute for specific advice on a particular matter from a suitably qualified professional person. For relevant accounting requirements, reference must be made to the Standard issued by the Board.

Any names of individuals, companies and/or places used in this publication are fictitious and any resemblance to real people, entities or places is purely coincidental.

Right of use: Although the Foundation encourages you to use this module for educational purposes, you must do so in accordance with the terms of use below. If you intend to include our material in a commercial product, please contact us as you will need a separate licence. For details on using our Standards, please visit www.ifrs.org/issued-standards.

You must ensure you have the most current material available from our website. Your right to use this module will expire when this module is withdrawn or updated, at which time you must cease to use it and/or make it available. It is your sole responsibility to ensure you are using relevant material by checking the Foundation's website for any amendments to the Standard, SME Implementation Group Q&As not yet incorporated and/or new versions of the modules.

Terms of Use

- 1) You can only reproduce the module in whole or in part in a printed or electronic stand-alone document provided that:
 - (a) such document is supplied to participants free of charge;
 - (b) you do not use or reproduce, or allow anyone else to use or reproduce, the Foundation logo that appears on or in the module;
 - (c) you do not use or reproduce any trade mark that appears on or in the module if you are using all or part of the material to incorporate into your own documentation; and
 - (d) you can only provide this module in whole through your website if you include a prominent link to our website (please see our [terms and conditions](#) page for details on how to link your website to ours).
- 2) The trade marks include those listed below.
- 3) When you copy any extract from this publication for inclusion in another document you must ensure:
 - (a) the documentation includes a copyright acknowledgement;
 - (b) the documentation includes a statement that the Foundation is the author of the module and that the original module can be accessed via the IFRS website www.ifrs.org;
 - (c) the documentation includes in a prominent place an appropriate disclaimer, like that shown above;
 - (d) the extract is shown accurately; and
 - (e) the extract is not used in a misleading context.

If you intend to provide any part of this module in print or electronically for any other purpose, please contact the Foundation as you will need a written licence which may or may not be granted. For more information, please contact the licences team (www.ifrs.org/legal/education-material-licensing).

Please address publication and copyright matters to IFRS Foundation Publications Department:

Email: publications@ifrs.org Web: www.ifrs.org

Trade mark notice



The IFRS Foundation has trade marks registered around the world, including 'eIFRS[®]', 'International Accounting Standards[®]', 'IAS[®]', 'IASB[®]', the IASB[®] logo, 'IFRIC[®]', 'International Financial Reporting Standards[®]', 'IFRS[®]', the IFRS[®] logo, 'IFRS Foundation[®]', 'IFRS for SMEs[®]', the IFRS for SMEs[®] logo, the 'Hexagon Device', 'NIIF[®]' and 'SIC[®]'. Further details of the IFRS Foundation's trade marks are available from the IFRS Foundation on request.

Contents

INTRODUCTION	1
Which version of the <i>IFRS for SMEs</i> Standard?	1
This module	1
<i>IFRS for SMEs</i> Standard	2
Introduction to the requirements	3
What has changed since the 2009 <i>IFRS for SMEs</i> Standard	5
REQUIREMENTS AND EXAMPLES	6
Scope of Sections 11 and 12	6
Accounting policy choice	7
Introduction to Section 11	8
Scope of Section 11	15
Basic financial instruments	17
Initial recognition of financial assets and liabilities	30
Initial measurement	31
Subsequent measurement	42
Derecognition of a financial asset	79
Derecognition of a financial liability	87
Disclosures	91
SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS	99
Initial measurement	99
Subsequent measurement	100
Derecognition	100
COMPARISON WITH FULL IFRS STANDARDS	101
TEST YOUR KNOWLEDGE	103
APPLY YOUR KNOWLEDGE	107
Case study 1	107
Answer to case study 1	109
Case study 2	112
Answer to case study 2	114

Module 11—Basic Financial Instruments

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015. This module has been prepared by IFRS Foundation education staff. The contents of Section 11 *Basic Financial Instruments* of the *IFRS for SMEs* Standard are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* Standard (Glossary) is also part of the requirements. Terms defined in the Glossary are reproduced in **bold type** the first time they appear in the text of Section 11. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs*[®] Standard?

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the IFRS for SMEs* Standard.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

An entity must choose to account for financial instruments either by applying the requirements of both Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments* in full or by applying the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (of full IFRS Standards) and the disclosure requirements of Sections 11 and 12. This training material covers only the first option (that is, it does not cover the option to apply IAS 39). Whichever of the options an entity applies, it must also apply Section 22 *Equity and Liabilities*.

This module focusses on the accounting and reporting of basic financial instruments in accordance with Section 11 of the *IFRS for SMEs* Standard. Module 12 applies to all other

Module 11—Basic Financial Instruments

financial instrument issues and hence covers more complex financial instruments and related transactions including hedge accounting.

The module identifies the significant judgements required to account for and report basic financial instruments and transactions. In addition, the module includes questions designed to test your understanding of the requirements and case studies that provide a practical opportunity to apply the requirements to account for and report basic financial instruments applying the *IFRS for SMEs* Standard.

Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

- define a financial instrument, a financial asset, a financial liability and an equity instrument;
- identify financial assets and financial liabilities that are within the scope of Section 11;
- explain when to recognise a financial instrument and demonstrate how to account for financial instruments on initial recognition;
- measure a financial instrument within the scope of Section 11 both on initial recognition and subsequently;
- determine amortised cost of a financial instrument using the effective interest method;
- identify when to recognise an impairment loss (or reversal of an impairment loss) for financial instruments held at cost or amortised cost, and demonstrate how to measure that impairment loss (or the reversal of an impairment loss);
- identify appropriate methods of determining fair value for investments in ordinary or preference shares;
- explain when to derecognise financial assets and financial liabilities and demonstrate how to account for such derecognition;
- prepare appropriate information about financial instruments that would satisfy the disclosure requirements in Section 11; and
- demonstrate an understanding of the significant judgements that are required in accounting for basic financial instruments.

***IFRS for SMEs* Standard**

The *IFRS for SMEs* Standard is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* Standard includes mandatory requirements and other non-mandatory material that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;

Module 11—Basic Financial Instruments

- the Basis for Conclusions, which summarises the Board’s main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the *IFRS for SMEs* Standard, Appendix A: Effective date and transition, and Appendix B: Glossary of terms, are part of the mandatory requirements.

In the *IFRS for SMEs* Standard, there are appendices to Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue*. These appendices provide non-mandatory guidance.

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board on matters related to the implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as “questions and answers” (Q&As). The Q&As provide non-mandatory, timely guidance on specific accounting questions raised with the SMEIG by users implementing the *IFRS for SMEs* Standard. At the time of issue of this module (July 2018) the SMEIG has issued one Q&A for Section 12, which is also relevant to this module.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity’s financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit-rating agencies.

Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* specify the financial reporting requirements for financial instruments. 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.

The *IFRS for SMEs* Standard contains two options for accounting for financial instruments:

- applying the requirements of both Section 11 and Section 12 in full; or
- applying the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement*¹ (of full IFRS Standards) and the disclosure requirements of Sections 11 and 12.

Whichever of the options an entity applies, it must also apply Section 22 *Liabilities and Equity*, which establishes principles for classifying financial instruments as either liabilities or equity and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (that is, in their capacity as owners).

¹ If this option is selected, an entity shall apply the version of IAS 39 that applied immediately prior to IFRS 9 superseding IAS 39. A copy of that version is available on the IASB website (ifrs.org – Home < Supporting implementation < IFRS for SMEs < IFRS for SMEs and IAS 39).

Module 11—Basic Financial Instruments

Scope

This module covers only the requirements in Section 11. Section 11 applies to basic financial instruments and is relevant to all entities that assert compliance with the *IFRS for SMEs* Standard. Section 12 applies to other, more complex financial instruments and transactions.

For the purposes of Section 11, basic financial instruments consist of:

- cash;
- debt instruments (such as an account, note, or loan receivable or payable) that meet certain conditions (in particular, returns to the holder are either fixed or are variable on the basis of a single referenced quoted or observable interest rate);
- commitments to receive a loan that cannot be settled net in cash and the loan is expected to meet the same conditions as other debt instruments in this section; and
- investments in non-convertible preference shares and non-puttable ordinary shares or preference shares.

Deciding whether an asset or liability that arises from a contract is a basic financial instrument accounted for in accordance with Section 11 involves a number of steps:

- Step 1: The contract must give rise to a financial asset of one entity and a financial liability or equity instrument of another entity (see paragraph 11.3)
- Step 2: The entity must have elected to account for financial instruments in accordance with Sections 11 and 12 (see paragraph 11.2)
- Step 3: The financial instrument must not be specifically excluded from the scope of Section 11 (see paragraph 11.7)
- Step 4: The financial instrument must be (a) cash or (b) an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares or (c) a debt instrument that satisfies the requirements in paragraph 11.9 or (d) a commitment to receive a loan that cannot be settled net in cash and, when the commitment is executed, is expected to meet the conditions in paragraph 11.9 (see paragraph 11.8).

Recognition

Section 11 requires a financial asset or financial liability to be recognised only when the entity becomes a party to the contractual provisions of the instrument.

Measurement

When first recognised, financial instruments are measured at their transaction price, unless the arrangement constitutes, in effect, a financing transaction. If the arrangement constitutes a financing transaction, the item is initially measured at the present value of the future receipts discounted at a market rate of interest for a similar debt instrument.

After initial recognition an amortised cost model (or in some cases a cost model) is applied to measure all basic financial instruments, except for investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably without undue cost or effort. For such investments, this section requires measurement after initial recognition at fair value with changes in fair value recognised in profit or loss.

Module 11—Basic Financial Instruments

This section requires that at the end of each reporting period, an assessment be made of whether there is objective evidence of impairment of any financial asset that is measured at cost or amortised cost.

If there is objective evidence of impairment, an impairment loss is recognised in profit or loss immediately. 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, the previously recognised impairment loss is reversed. However, the reversal must not result in a carrying amount of the financial asset that exceeds what the carrying amount would have been had the impairment not previously been recognised.

What has changed since the 2009 *IFRS for SMEs*

The following are the changes made to Section 11 by the 2015 Amendments:

- addition of an undue cost or effort exemption from the measurement of investments in equity instruments at fair value (see paragraphs 11.4, 11.14(c), 11.32 and 11.44).
- clarification of the interaction of the scope of Section 11 with other sections of the IFRS for SMEs Standard (see paragraph 11.7(b)–(c) and (e)–(f)).
- clarification of the application of the criteria for basic financial instruments to simple loan arrangements (see paragraphs 11.9–11.9B).
- clarification of when an arrangement would constitute a financing transaction (see paragraphs 11.13, 11.14(a) and 11.15).
- clarification in the guidance on fair value measurement in Section 11 of when the best evidence of fair value may be a price in a binding sale agreement (see paragraph 11.27).

Module 11—Basic Financial Instruments

REQUIREMENTS AND EXAMPLES

The contents of Section 11 *Basic Financial Instruments* of the *IFRS for SMEs* Standard are set out below and shaded grey. Terms defined in the Glossary are also part of the requirements. They are in **bold type** the first time they appear in the text of Section 11. The notes and examples inserted by the IFRS Foundation education staff are not shaded. The insertions made by the staff do not form part of the *IFRS for SMEs* Standard and have not been approved by the International Accounting Standards Board.

Scope of Sections 11 and 12

11.1 Section 11 and Section 12 *Other Financial Instrument Issues* together deal with recognising, derecognising, measuring and disclosing **financial instruments (financial assets and financial liabilities)**. Section 11 applies to basic financial instruments and is relevant to all entities. Section 12 applies to other, more complex financial instruments and transactions. If an entity enters into only basic financial instrument transactions then Section 12 is not applicable. However, even entities with only basic financial instruments shall consider the scope of Section 12 to ensure they are exempt.

Notes

It is a common misconception that financial instruments appear only in the financial statements of banks and insurance entities, both of which are outside the scope of the *IFRS for SMEs* Standard (see paragraphs 1.2 and 1.3). Another common, but incorrect, belief is that requirements for accounting for financial instruments only apply to entities that enter into complex financial instrument transactions, such as hedging and speculative transactions involving items such as futures and options.

However, the definition of a financial instrument is very broad, encompassing instruments from simple receivables and payables and investments in debt or equity instruments, to complex derivative transactions. Virtually all entities have financial instruments such as cash, trade receivables, trade payables, overdrafts and bank loans in their statement of financial position. Consider, for example, an entity that buys goods from a supplier on credit (giving rise to a financial liability—trade payable) and sells the goods to its customers on credit (giving rise to a financial asset—trade receivable). Consider also, an entity that borrows money from a bank. This transaction gives rise to a financial asset (the cash received) and a financial liability (the obligation to repay the loan). These financial assets and financial liabilities are usually accounted for in accordance with Section 11.

Accounting for financial instruments is sometimes perceived as complex because of the extent of the requirements and related guidance to account for complex financial instruments. However, accounting for basic financial instruments in accordance with Section 11 of the *IFRS for SMEs* Standard is relatively straightforward and does not require complex measurements.

Module 11—Basic Financial Instruments

Few small or medium-sized entities hold the complex financial instruments. The requirements to account for complex financial instruments are not relevant to those entities that hold only basic financial instruments. The requirements for accounting for financial instruments are therefore split into two sections—Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues*. The requirements for straightforward instruments are separated from the requirements for the complex instruments, making it easier for entities to identify the requirements that apply to them.

As its title suggests, Section 11 addresses basic financial instruments and basic transactions involving financial instruments that small or medium-sized entities commonly encounter. In contrast, Section 12 addresses the more complex financial instruments and transactions that few private entities encounter. However, all entities must review Section 12 to ensure that none of their financial instruments or transactions fall within its scope. Even entities that normally engage in only simple transactions may occasionally enter into more unusual transactions to which Section 12 applies. See paragraph 11.11 for examples of financial instruments that are within the scope of Section 12.

Accounting policy choice

11.2 An entity shall choose to apply either:

- (a) the requirements of both Sections 11 and Section 12 in full; or
- (b) the **recognition** and **measurement** requirements of IAS 39 *Financial Instruments: Recognition and Measurement*¹ and the disclosure requirements of Sections 11 and 12

to account for all of its financial instruments. An entity's choice of (a) or (b) is an accounting policy choice. Paragraphs 10.8–10.14 contain requirements for determining when a change in accounting policy is appropriate, how such a change should be accounted for and what information should be disclosed about the change.

¹ Until IAS 39 is superseded by IFRS 9 *Financial Instruments*, an entity shall apply the version of IAS 39 that is in effect at the entity's reporting date, by reference to the full IFRS publication entitled *International Financial Reporting Standards IFRS® Consolidated without early application* (Blue Book). When IAS 39 is superseded by IFRS 9, an entity shall apply the version of IAS 39 that applied immediately prior to IFRS 9 superseding IAS 39. A copy of that version will be retained for reference on the SME webpages of the IASB website (<http://go.ifrs.org/IFRSforSMEs>).

Notes

An entity must select as an accounting policy choice either the option in paragraph 11.2(a) or the option in paragraph 11.2(b). It must apply this option to account for all of its financial instruments.

Many preparers find IAS 39 more complex and difficult to apply than Sections 11 and 12. However, an entity may choose the option in paragraph 11.2(b), for example, if it holds complex financial instruments or enters into hedging relationships. Before choosing to apply IAS 39 an entity should consider carefully whether it has the resources to do so.

Module 11—Basic Financial Instruments

Once an entity has made its choice, changing to the other option (for example, from (a) to (b)) constitutes a change in accounting policy, as described in Section 10 *Accounting Policies, Estimates and Errors* (paragraphs 10.8–10.14). Paragraph 10.8 specifies that the entity can only make such a change if doing so would result in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. The change in accounting policy would be accounted for retrospectively (that is, by restating the comparative financial information presented as if the new accounting policy had always been applied) and the disclosures required by paragraph 10.14 would be provided.

Introduction to Section 11

11.3 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.

Notes

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

For the purposes of Section 11, a financial asset can be described as any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another financial asset from another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.
- (d) a contract that will or may be settled in the entity's own equity instruments and under which the entity is or may be obliged to receive a variable number of the entity's own equity instruments.

For the purposes of Section 11, a financial liability can be described as any liability that is:

- (a) a contractual obligation:
 - (i) to deliver cash or another financial asset to another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- (b) a contract that will or may be settled in the entity's own equity instruments and under which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments.

Module 11—Basic Financial Instruments

For simplicity, these descriptions of a financial asset and a financial liability differ slightly from the definitions of a financial asset and a financial liability in the *IFRS for SMEs* Standard (see the Glossary), but are suitable for the purposes of Module 11. A financial asset or financial liability that meets the definitions in the Glossary but not the descriptions is probably outside the scope of Section 11, and would be accounted for in accordance with Section 12. This is explained further in Section 12.

It is evident from the descriptions above that financial instruments arise from rights and obligations under contracts. The terms ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. For a contract to be valid, both parties must give their approval. Approval may be given indirectly, for example, by an entity acting in such a way that the other parties involved believe the entity’s intention is to make a contract. For example, an entity that purchases or sells goods or property, engages a builder to carry out work, borrows money or orders goods or machinery from a manufacturer is a party to a contract.

Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

<i>Financial asset—contractual right</i>	<i>Financial liability—contractual obligation</i>
Trade accounts receivable	Trade accounts payable
Notes receivable	Notes payable
Bonds receivable	Bonds payable

In each case, one party’s contractual right to receive cash is matched by the other party’s corresponding obligation to pay cash.

Examples—financial instruments

Ex 1 A bank advances an entity a five-year loan. The bank also provides the entity with an overdraft facility for a number of years.

The entity has two financial liabilities—the obligation to repay the five-year loan and the obligation to repay the bank overdraft to the extent that it has borrowed using the overdraft facility. Both the loan and the overdraft result in contractual obligations for the entity to pay cash to the bank for the interest incurred and for the return of the principal (see paragraph (a)(i) of the definition of a financial liability in the Glossary).

The amounts due from the entity under the loan and overdraft facility are financial assets of the bank. Note: The bank cannot apply the *IFRS for SMEs* Standard (see paragraphs 1.2 and 1.3).

Module 11—Basic Financial Instruments

Ex 2 Entity A owns preference shares in Entity B. The preference shares entitle Entity A to dividends, but not to any voting rights.

Entity B: The preference shares may be equity instruments or financial liabilities of Entity B, depending on their terms and conditions (see Section 22 *Liabilities and Equity*).

Entity A: Irrespective of Entity B's treatment, the preference shares are a financial asset because the investment will either satisfy part (b) or (c)(i) of the definition of a financial asset. The financial asset will usually be within the scope of Section 11 (see paragraph 11.8).

Ex 3 An entity (the purchaser) buys goods from a supplier on 60 days' credit.

The purchaser has a financial liability (trade payable)—a contractual obligation to deliver cash to its supplier in settlement of the purchase price (see part (a)(i) of the definition of a financial liability in the Glossary).

The supplier has a corresponding financial asset (a trade receivable)—a contractual right to receive cash (the amount due from the purchaser) (see part (c)(i) of the definition of a financial asset in the Glossary).

Ex 4 Entity A purchases a subsidiary from Entity B. Under the agreement, Entity A pays the purchase price in two instalments—CU5 million⁽²⁾ upfront and a further payment (which is not a contingent payment) of CU5 million two years later.

The CU5 million payable two years later is a financial liability of Entity A—it is an obligation to deliver cash in two years' time (see part (a)(i) of the definition of a financial liability in the Glossary). It is a financial asset of Entity B—a contractual right to receive cash (see part (c)(i) of the definition of a financial asset in the Glossary).

Examples—not financial instruments

Ex 5 An entity has a present obligation in respect of income tax due for the prior year.

An income tax liability is created as a result of statutory requirements imposed by governments. The rights and obligations are not created by a contract and hence the liability does not satisfy the requirements of 11.3 and is not a financial liability.

Accounting for income tax is dealt with in Section 29 *Income Tax*.

Ex 6 Every year for the past 20 years a catering entity has paid CU50,000 towards the costs of the carnival in the village in which the entity operates. The entity is well known as the main sponsor of the annual event and its advertisements include reference to its status as main sponsor of the village carnival. The villagers now expect the entity to pay CU50,000 to cover the costs of the carnival this year.

The obligation to pay CU50,000 does not arise from a contract and hence is not a financial liability. The obligation may meet the conditions to be recognised as a constructive obligation. A constructive obligation falls within the scope of Section 21 *Provisions and Contingencies*.

Note: If, however, the catering entity entered into a contract to pay CU50,000 towards the village carnival, then the entity has a financial liability.

⁽²⁾ In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

Module 11—Basic Financial Instruments

- Ex 7** In a lawsuit brought against an entity, a group of people is seeking compensation for damage to their health as a result of land contamination believed to be caused by waste from the entity's production process. It is unclear whether the entity is the source of the contamination since many entities operate in the same area and produce similar waste.

The fact that a lawsuit may result in the payment of cash does not create a financial liability for the entity because there is no contract between the entity and the affected group. The entity will need to consider providing for the payment under Section 21 *Provisions and Contingencies*.

- Ex 8** An entity is fined for three separate breaches of legislative requirements: (i) the late payment of income tax; (ii) failing to submit its company accounts on time; and (iii) false claims made in advertisements for its products.

Fines do not arise from contracts. They are levied because of breaches of statutory requirements and therefore, are not financial liabilities of the entity. Since the entity must pay the fines, the entity will need to consider recognising a liability in accordance with Section 2 *Concepts and Pervasive Principles*. If the payment is of uncertain timing or amount, it is accounted for in accordance with Section 21 *Provisions and Contingencies*.

- Ex 9** An entity acquires a license to produce and sell a well-known international beverage in its jurisdiction.

Intangible assets (such as acquired patents and licences) are not financial assets. Control of intangible assets may create an opportunity to generate an inflow of cash or another financial asset, but they do not give rise to a present right to receive cash or another financial asset under a contract and are not financial assets.

- Ex 10** At the end of the reporting period an entity has an asset—the prepayment of three months of rent on its office building.

Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services rather than the right to receive cash or another financial asset, are not financial assets.

Similarly, accruals for which the future outflow of benefits is the delivery of goods or services, rather than the payment of cash or financial assets, are not financial liabilities.

- Ex 11** An entity sells goods to customers. The law in the entity's jurisdiction requires that the entity provides a one-year guarantee to repair or replace any defective products.

The warranty obligation is not a financial liability because there is no contract between the entity and its customers. The customers have a statutory right to demand repair or replacement of defective products. The warranty provision is accounted for in accordance with Section 21 *Provisions and Contingencies*.

Module 11—Basic Financial Instruments

Ex 12 An entity leases a machine from a machine manufacturing entity under a five-year operating lease.

Paragraph 11.7(c) scopes out leases to which Section 20 Leases or paragraph 12.3(f) apply. However, the derecognition requirements of Section 11 apply to lease receivables recognised by a lessor and lease payables recognised by a lessee. Furthermore, the impairment requirements of Section 11 apply to lease receivables recognised by a lessor. Accordingly, an operating lease is not regarded as a financial instrument, except as regards individual payments currently due and payable (for example, an amount due in payment for a lease period that has already passed).

Ex 13 An entity buys gold bullion as an investment.

Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion. Gold bullion is a commodity, not a financial asset.

Ex 14 An entity is both the policyholder and the beneficiary in a life insurance (also known as life assurance) contract. The contract requires the insurer to pay the entity a sum of money upon the death or terminal illness of the owner-manager of the entity. Under the contract, the entity is required to pay a stipulated amount annually until the insured event (death or illness) occurs.

A policyholder's contractual right to receive cash under the contract meets the definition of a financial asset. However, such financial assets do not typically meet the requirements in paragraph 11.9, and are therefore not typically accounted for in accordance with Section 11 (see Example 16 and 17).

11.4 Section 11 requires an amortised cost model for all basic financial instruments except for investments in non-convertible preference shares and non-puttable ordinary or preference shares that are **publicly traded** or whose **fair value** can otherwise be measured reliably without undue cost or effort.

Notes

Amortised cost is explained in paragraphs 11.15–11.20. An example of how to compute amortised cost is set out below paragraph 11.20.

Investments in non-convertible preference shares and non-puttable ordinary shares or preference shares that are publicly traded or whose fair value can otherwise be measured reliably without undue cost or effort are measured after initial recognition at fair value with changes in fair value recognised in profit or loss (see paragraph 11.14(c)(i)). This sole exemption to the amortised cost model in Section 11 is driven by the circumstances—it applies only to instruments whose fair value can be measured reliably without undue cost or effort.

If the fair value of such instruments cannot be measured reliably without undue cost or effort, they are measured at cost less impairment (see paragraph 11.14(c)(ii)). Measuring fair value is unlikely to be onerous because, in accordance with paragraph 11.4, the requirement applies only to instruments whose fair value can be measured reliably without undue cost or effort.

Module 11—Basic Financial Instruments

Whether determining the fair value would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement in assessing the costs and benefits. Management must consider how the absence of such information could affect the economic decisions of those expected to use the financial statements.

Applying the requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceeded the benefits that having the information would provide to those expected to use the SME's financial statements (see paragraph 2.14B). If an SME already has, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any related exemption on the grounds of undue cost or effort would no longer apply. This is because, in such cases, the benefits to users of the financial statements of having the information, would be expected to exceed any further cost or effort by the SME. Assessing whether a requirement would involve undue cost or effort on initial recognition in the financial statements, for example at the date of the transaction, should be based on information about the costs and benefits at that date. If the undue cost or effort exemption also applies after initial recognition, for example to a subsequent measurement of an item, a new assessment of undue cost or effort should be made at that subsequent date, based on information available at that date (see paragraph 2.14C). Where an entity uses the undue cost or effort exemption for financial instruments, the entity shall disclose that fact and the reasons why applying the requirement would involve undue cost or effort (see paragraph 2.14D).

- 11.5 Basic financial instruments within the scope of Section 11 are those that satisfy the conditions in paragraph 11.8. Examples of financial instruments that normally satisfy those conditions include:
- (a) **cash;**
 - (b) demand and fixed-term deposits when the entity is the depositor, for example 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 preference shares and non-puttable ordinary and preference shares; and
 - (g) commitments to receive a loan if the commitment cannot be net settled in cash.

Example—commercial paper

Ex 15 An entity holds commercial paper (an unsecured, short-term debt instrument) issued by a large corporation.

The commercial paper held by the entity is a basic financial instrument—the holder's contractual right to receive cash (financial asset) is matched by the issuer's corresponding obligation to pay (financial liability).

Module 11—Basic Financial Instruments

Example—bonds

Ex 16 An entity holds bonds issued by a large corporation.

A bond is a debt security—the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay the coupon (ie the annual interest rate paid on a bond or similar instrument) and to repay the principal at a specified maturity date. It is a formal contract to repay borrowed money, and interest is typically payable at fixed intervals.

The bonds held by the entity are basic financial instruments—the bond-holder's contractual right to receive cash (financial asset) is matched by the large corporation's corresponding obligation to pay (financial liability).

11.6 Examples of financial instruments that do not normally satisfy the conditions in paragraph 11.8, and are therefore within the scope of Section 12, 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;
- (c) financial instruments that qualify and are designated as **hedging instruments** in accordance with the requirements in Section 12;
- (d) commitments to make a loan to another entity; and
- (e) commitments to receive a loan if the commitment can be net settled in cash.

Notes

An asset-backed security (paragraph 11.6(a)) is a security whose value and income payments are derived from and collateralised (that is, supported) by a specified pool of underlying assets.

The items in paragraph 11.6(b) are often referred to as derivatives because their value derives from an independent underlying variable such as a price, rate or index. All derivatives fall outside the scope of Section 11 and are accounted for in accordance with Section 12. Other types of derivatives are listed in example 22.

Paragraph 11.6(c) refers to hedging instruments. Hedge accounting is optional, and many entities may choose not to apply it because of its complexity. Should an entity choose to apply hedge accounting, it must comply with the conditions in Section 12. Hedge accounting is a method of presentation that an entity may choose to apply to a transaction if the entity and that transaction meet specified criteria. If a transaction qualifies for hedge accounting and an entity chooses to apply hedge accounting the financial instrument designated as the hedging instrument will fall outside the scope of Section 11.

Module 11—Basic Financial Instruments

Scope of Section 11

- 11.7 Section 11 applies to all financial instruments meeting the conditions of paragraph 11.8 except for the following:
- (a) investments in **subsidiaries, associates and joint ventures** that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Investments in Joint Ventures*.
 - (b) financial instruments that meet the definition of an entity's own equity, including the equity component of **compound financial instruments** issued by the entity (see Section 22 *Liabilities and Equity*).
 - (c) **leases**, to which Section 20 *Leases* or paragraph 12.3(f) apply. However, the **derecognition** requirements in paragraphs 11.33–11.38 apply to the derecognition of lease receivables recognised by a lessor and lease payables recognised by a lessee, and the impairment requirements in paragraphs 11.21–11.26 apply to lease receivables recognised by a lessor.
 - (d) employers' rights and obligations under **employee benefit** plans, to which Section 28 *Employee Benefits* applies.
 - (e) financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 *Share-based Payment* applies.
 - (f) reimbursement **assets** that are accounted for in accordance with Section 21 *Provisions and Contingencies* (see paragraph 21.9).

Notes

All interests in subsidiaries, associates and joint ventures that are accounted for in accordance with Section 9, 14 or 15 respectively are outside the scope of Section 11 even though the equity shares or other instruments representing those interests are financial instruments. However, the fair value model under those three sections refers to some paragraphs of Section 11 that are applicable. For entities using the fair value model for investments under Section 9, 14 or 15, the only paragraphs from Section 11 that should be applied are those listed in these sections. No other part of Section 11 should be applied.

Section 22 *Liabilities and Equity* establishes principles to guide issuers with classifying financial instruments as either financial liabilities or equity. Therefore Section 22 is applied first to determine whether a financial instrument is a financial asset, a financial liability, equity or a compound financial instrument (an instrument that contains both equity and liability components—see Glossary).

Section 11 applies to those instruments that are financial assets or financial liabilities, and to the liability component of a compound financial instrument. Section 11 does not apply to financial instruments, or components of financial instruments, that meet the definition of that entity's own equity instruments, for example an issuer's ordinary shares and preference shares that do not satisfy the definition of a financial liability. The exemption applies only to the issuer of the equity instrument. The holder of the instrument should apply Section 11 unless the investment is excluded by paragraph 11.7(a) or does not meet the criteria in paragraph 11.8(d).

Module 11—Basic Financial Instruments

Finance leases result in financial instruments. A finance lease is regarded as an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than accounting for the leased asset itself. For example, a finance lease between two parties creates a lease receivable (financial asset) for the lessor and a lease payable (financial liability) for the lessee. As Section 20 *Leases* contains specific requirements for finance leases, these are outside the scope of Section 11.

A provision for an onerous contract (for example, provision for future lease payments for vacant leasehold property) is a financial liability as it arises from the unavoidable cost of meeting the obligations under the contract. However, onerous contract provisions are excluded from this section and are accounted for in accordance with Section 21 *Provisions and Contingencies*.

Employee rights and obligations under employee benefit plans are financial instruments, because they are contractual rights or obligations that will result in the flow of cash to past and present employees. However, as they are specifically accounted for under Section 28 *Employee Benefits*, they are outside the scope of Section 11.

Financial instruments, contracts and obligations under share-based payment arrangements to which Section 26 *Share-based Payment* applies are excluded from the scope of Section 11. However, the scope of Section 22 makes it clear that treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans and other share-based payment arrangements are within the scope of Section 22.

A reimbursement asset exists when some or all of the amount required to settle a provision may be reimbursed by another party (for example, through an insurance claim). A reimbursement asset is a financial asset as it represents a contractual right to receive cash from another entity. However, reimbursement assets are outside the scope of Section 11. Paragraph 21.9 (Section 21) contains specific requirements for reimbursement assets. Such rights are recognised as separate assets only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation in accordance with paragraph 21.9.

Example—subsidiaries, associates and jointly controlled entities

Ex 17 A holding company (investor) has investments in several entities (investees). All the investees are either subsidiaries, associates or jointly controlled entities of the investor and are accounted for applying Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* and Section 15 *Investments in Joint Ventures*.

Investor's perspective: The holdings of shares in subsidiaries, associates and jointly controlled entities are financial assets of the holding company.

Investees' perspective: As investments can be achieved in a number of ways, the investee needs to analyse whether the instruments are equity instruments or financial liabilities (see Section 22). If the investee concludes that the instruments are a financial liability, they are accounted for applying Section 11.

Module 11—Basic Financial Instruments

All financial assets and equity instruments in this example are excluded from Section 11 (see paragraph 11.7(a)). If the instruments are financial liabilities of the investees and satisfy paragraph 11.8, the investee will need to account for the financial liabilities in its own individual financial statements, in accordance with Section 11.

Example— share-based payment transactions

- Ex 18** Entity A, as part of its ordinary activities, contracted for advice regarding a new marketing campaign from a local PR consultancy. The consultancy agreed to accept ordinary shares of Entity A as payment for its services.

Entity A is paying for services in shares rather than in cash. It accounts for this equity-settled share-based payment transaction applying Section 26.

Example—reimbursement asset

- Ex 19** The facts are the same as in Example 14. Prior to the year end, the owner-manager of the entity becomes ill, and a claim of CU20,000 is lodged with the insurance company. The claim has not been settled by the year-end. The entity is obliged under a co-operation contract with Entity B to pay an amount of CU10,000 to Entity A in the event of the death or illness of the owner manager.

A policyholder's contractual right to receive cash under the contract meets the definition of a financial asset. This is a reimbursement asset as per paragraph 21.9 because some or all of the amount required to settle a provision (the payment to Entity B) is reimbursed by another party (the insurer). Paragraph 21.9 (Section 21) contains specific requirements for reimbursement assets. Such rights are recognised as separate assets only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation in accordance with paragraph 21.9.

Basic financial instruments

- 11.8 An entity shall account for the following financial instruments as basic financial instruments in accordance with Section 11:
- (a) cash;
 - (b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9;
 - (c) a commitment to receive a loan that:
 - (i) cannot be settled net in cash; and
 - (ii) when the commitment is executed, is expected to meet the conditions in paragraph 11.9.
 - (d) an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.

Module 11—Basic Financial Instruments

Notes

A debt instrument is a contractual or written assurance to repay a debt. Debt instruments are created when one entity provides money, goods or services to another entity. Examples are deposits held in banks, trade receivables and payables, bank loans, loan assets and other loans purchased in a market.

Such a debt instrument is a financial asset of the entity that is owed the debt and a financial liability of the entity that is required to pay the debt. An equity instrument or an investment in an equity instrument is not a debt instrument. To be within the scope of Section 11, a debt instrument must meet the requirements in paragraph 11.9.

A commitment to receive a loan arises when there is a firm promise, usually from a bank, to provide credit to an entity under specified terms and conditions. Such commitments may provide the entity with an option to borrow money at a future date or may require the entity to borrow money. If, in effect, the lender has written *an option* that allows the potential borrower to obtain a loan at a specified rate, the loan commitment is a financial instrument accounted for in accordance with Section 12.

To fall within the scope of Section 11, investments in ordinary or preference shares must be non-puttable. Paragraph 22.4 explains that a puttable instrument is a financial instrument that gives the holder the right to sell that instrument back to the issuer for cash or another financial asset on exercise of the put or is automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Therefore, an entity has an investment in non-puttable shares if:

- the entity does not have an option to sell the shares back to the issuer of the shares for cash or another financial asset; and
- there is no arrangement that could result in the shares being automatically sold or returned to the issuer because of a future event.

For investments in preference shares to be within the scope of Section 11 they must be non-convertible (that is, incapable of being converted into ordinary shares). A conversion feature would link the value of the preference share to an external variable and, therefore, bring it within the scope of Section 12.

Investments in puttable ordinary or preference shares and in convertible preference shares are outside the scope of Section 11. They are accounted for in accordance with Section 12, unless they are investments in subsidiaries, associates or joint ventures that are accounted for in accordance with Section 9, 14 or 15 (see paragraph 11.7).

An example of what would commonly fail the simplicity test in paragraph 11.8. are derivatives. They are consequently outside the scope of Section 11. They are neither debt instruments as described in paragraph 11.8(b) nor investments in shares as described in paragraph 11.8(d). Derivatives are within the scope of Section 12 unless they meet the definition of an entity's own equity (see Section 22 *Liabilities and Equity* and Section 26 *Share-based Payment*).

Module 11—Basic Financial Instruments

Other derivatives are part of another financial instrument or a contract to buy or sell a non-financial item, for example a loan with interest payments that are linked to the price of a commodity. If a derivative is embedded in or combined with another financial instrument, the conditions in paragraph 11.9 should be assessed against the instrument as a whole. If the conditions are satisfied for the instrument as a whole, that instrument is accounted for in accordance with Section 11.

A derivative embedded in a contract will cause the whole financial instrument to fall outside the scope of Section 11 and within the scope of Section 12. However, exceptions apply—for example, instruments specifically excluded from Section 12 in accordance with paragraph 12.3(b)–(f).

The following are examples of financial instruments that are likely to be complex and therefore in Section 12:

- foreign currency forward exchange contracts;
- commodity forward exchange contracts;
- equity forward exchange contracts;
- treasury forwards (interest rate forwards linked to government debt);
- foreign currency futures;
- commodity futures;
- treasury futures (interest rate futures linked to government debt);
- interest rate swaps;
- foreign currency swaps (also called foreign exchange swaps or cross currency swaps);
- commodity swaps;
- equity swaps;
- credit swaps;
- total return swaps;
- commitment to receive a loan;
- purchased or written treasury bond options (call or put);
- purchased or written currency options (call or put);
- purchased or written commodity options (call or put); and
- purchased or written stock options (call or put).

Module 11—Basic Financial Instruments

Examples—basic financial instruments

Ex 20 An entity has cash.

The cash is a financial asset of the entity (see part (a) of the definition of a financial asset in the Glossary). The entity must account for the cash in accordance with Section 11 (see paragraph 11.8(a)).

Note: Paragraph 11.9 does not apply to items specified in paragraph 11.8(a) and (d).

Ex 21 Entity A owns 0.5% of the non-puttable ordinary shares that carry voting rights at a general meeting of shareholders of Entity B.

The holding of ordinary shares in Entity B is a financial asset of Entity A—it is an equity instrument of another entity (see part (b) of the definition of a financial asset in the Glossary). Entity A must account for its investment in the non-puttable ordinary shares of Entity B in accordance with Section 11 (see paragraph 11.8(d)).

Note: Paragraph 11.9 does not apply to items specified in paragraph 11.8(a) and (d).

Example—commitment to receive a loan

Ex 22 In order to finance the construction of a new office building, an entity takes a loan from a bank. In accordance with the terms of the loan agreement the entity is committed to receiving a loan from the bank in 12 equal consecutive monthly instalments. The entity has a contractual obligation to repay the loan three years after the last instalment has been received from the bank. The loan bears interest at the fixed rate of 5% per year. The loan commitment cannot be settled net in cash. At all times the commitment has met the conditions in paragraph 11.9.

The commitment to receive the loan from the bank is accounted for in accordance with Section 11—it meets the conditions in paragraph 11.8(c).

Module 11—Basic Financial Instruments

- 11.9 A debt instrument that satisfies all of the conditions in (a)–(d) shall be accounted for in accordance with Section 11:
- (a) returns to the holder (the lender/creditor) assessed in the currency in which the debt instrument is denominated are either:
 - (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 such fixed rate and variable rates, provided that both the fixed and variable rates are positive (for example, an interest rate swap with a positive fixed rate and negative variable rate would not meet this criterion).
- For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.
- (b) there is no contractual provision that could, by its terms, result in the holder (the lender/creditor) losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.
 - (c) contractual provisions that permit or require the issuer (the borrower) to prepay a debt instrument or permit or require the holder (the lender/creditor) to put it back to the issuer (ie to demand repayment) before maturity are not contingent on future events other than to protect:
 - (i) the holder against a change in the credit risk of the issuer or the instrument (for example, defaults, credit downgrades or loan covenant violations) or a change in **control** of the issuer; or
 - (ii) the holder or issuer against changes in relevant taxation or law.
 - (d) there are no conditional returns or repayment provisions except for the variable rate return described in (a) and prepayment provisions described in (c).

Notes

In accordance with Section 11, all debt instruments that satisfy the criteria in paragraph 11.9 are, after initial recognition, measured using an amortised cost model (see paragraph 11.14(a)). If a debt instrument does not satisfy the criteria in paragraph 11.9 it is accounted for in accordance with Section 12 and measured at fair value.

If the contractual cash flows of a debt instrument consist only of principal (that is, the capital amount borrowed, which some call the ‘face value’ of the loan) and interest on that principal, then the debt instrument will usually be measured at cost or amortised cost in accordance with Section 11.

The effective interest method is not an appropriate method for allocating cash flows that are not principal or interest on the principal outstanding. Therefore, if a financial instrument contains contractual cash flows that are not principal or interest on the principal outstanding, amortised cost under Section 11 is unlikely to be an appropriate measurement basis.

Module 11—Basic Financial Instruments

Interest cash flows relate closely to the amount advanced to the debtor (that is, the principal amount) because interest is compensation for the time value of money and the credit risk associated with the instrument and its issuer.

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation (that is, failing to repay principal and interest in a timely manner).

To ensure that returns to the holder are intended only to provide interest on that principal, the criteria in paragraph 11.9 require that the returns to the holder must either be fixed or be variable on the basis of a single referenced quoted or observable interest rate. If there is significant uncertainty about the realisation of the cash flows receivable or payable, for reasons other than credit risk or fluctuations in a quoted or observable rate, for example, LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate), the debt instrument will not meet the criteria in paragraph 11.9 and will be accounted for at fair value in accordance with Section 12.

For debt instruments to satisfy paragraph 11.9(a) they must either have fixed returns, returns equal to a single referenced quoted or observable interest rate, or some combination of these fixed and variable rates. For such debt instruments the contractual arrangement will define the amounts and dates of payments, such as interest and principal payments. Debt instruments often have a fixed maturity date. Returns based on an index or rate other than a quoted or observable interest rate (for example a price index, a commodity index, or a government-published inflation rate) will not satisfy paragraph 11.9(a) and therefore, the related instrument is not accounted for at amortised cost.

If the contractual terms of a financial instrument could result in the holder losing the principal amount or any interest due (paragraph 11.9(b)), the returns to the holder are not certain to be fixed or variable based on a single referenced quoted or observable interest rate so. The instrument, therefore, would not be measured at amortised cost. An example would be a financial instrument with cash flows linked to the profits of the issuer.

A significant risk of non-payment does not preclude a financial asset meeting the requirements in paragraph 11.9 as long as its contractual payments are fixed or variable on the basis of a single quoted or observable interest rate as set out in paragraph 11.9(a) and all the other criteria in paragraph 11.9 are met. Although the holder may lose the principal amount or any interest attributable to the current period or prior periods if the debtor is unable to make payment due to financial difficulties, this is not a contractual provision and would not violate paragraph 11.9(b).

An option for a debtor to choose to prepay a debt instrument (for example, a loan) will not necessarily prevent an instrument from satisfying the requirements in paragraph 11.9 (see paragraph 11.9(c)). To satisfy the requirement in paragraph 11.9(c), the prepayment amount must be substantially equal to the unpaid amounts of principal and interest. Such prepayment provisions may include terms that require the issuer to compensate the holder for the early termination of the instrument. However, if the option to prepay is triggered by a contingent (that is, possible, but uncertain) future event, the debt instrument will not satisfy the requirement in paragraph 11.9(c) and is accounted for in accordance with Section 12. Such contingent future events must be considered uncertain when the contract is signed

Module 11—Basic Financial Instruments

and therefore, cannot be planned. They include, for example, a 50% decrease in the price of gold, an initial public offering of the issuer's shares, a business combination between the issuer and another party, the unexpected retirement of a major shareholder of the issuer or a change in tax or other legislation.

Any conditional returns or repayment provisions except for the variable rate return described in paragraph 11.9(a) and prepayment provisions described in paragraph 11.9(c) would mean that returns to the holder are not certain to be fixed or variable on the basis of a single referenced quoted or observable interest rate. Therefore, if such provisions exist, the debt instrument will not meet the requirements in paragraph 11.9 and will not qualify for amortised cost accounting (see paragraph 11.9(d)).

Sometimes an instrument has a feature that combines a fixed interest return and a variable interest return (for example, a variable rate debt instrument with an interest rate cap, collar or floor). Basic caps, collars and floors, by themselves, will not cause an instrument to violate the conditions in paragraph 11.9(a).

Example—insurance contract

Ex 23 The facts are the same as in Example 14. A policyholder's contractual right to receive cash under the contract meets the definition of a financial asset. However, the contractual rights in an insurance contract are conditional upon an uncertain future event (the death or illness of the owner manager while cover continues to be provided).

The rights do not meet the requirements in paragraph 11.9, and are consequently outside Section 11. Normally these rights are also outside the scope of Section 12 because of the exemption in paragraph 12.3(d). If the rights are outside the scope of Sections 11 and 12 the following apply:

- any contingent assets should be accounted for in accordance with Section 21 *Provisions and Contingencies*;
- any reimbursement rights (that is, when some or all of the amount required to settle a provision may be reimbursed by the insurer) shall also be accounted for in accordance with Section 21; and
- any further assets resulting from those rights must be recognised and measured in accordance with Section 2 *Concepts and Pervasive Principles*.

Module 11—Basic Financial Instruments

- 11.9A Examples of debt instruments that would normally satisfy the conditions in paragraph 11.9(a)(iv) include:
- (a) a bank loan that has a fixed interest rate for an initial period that then reverts to a quoted or observable variable interest rate after that period; and
 - (b) a bank loan with interest payable at a quoted or observable variable interest rate plus a fixed rate throughout the life of the loan, for example LIBOR plus 200 basis points.
- 11.9B An example of a debt instrument that would normally satisfy the conditions set out in paragraph 11.9(c) would be a bank loan that permits the borrower to terminate the arrangement early, even though the borrower may be required to pay a penalty to compensate the bank for its costs of the borrower terminating the arrangement early.
- 11.10 Other examples of financial instruments that would normally satisfy the conditions in paragraph 11.9 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.
 - (c) loans to or from subsidiaries or associates that are due on demand.
 - (d) a debt instrument that would become immediately receivable if the issuer defaults on an interest or principal payment (such a provision does not violate the conditions in paragraph 11.9).

Examples—satisfying the conditions in paragraph 11.9

Ex 24 Entity A owes (that is, has a contractual obligation to pay) Entity B CU10,000 for goods it purchased on 30 days' credit from Entity B on 30 December 20X0.

The debt instrument is a trade payable (financial liability) of Entity A and a trade receivable (financial asset) of Entity B. The debt instrument satisfies the requirement in paragraph 11.9(a)(i) and therefore, provided all the conditions in paragraph 11.9(b)–(d) are met, the debt instrument is accounted for in accordance with Section 11 by both Entity A and Entity B.

Ex 25 Entity A owes Entity B CU950 for 95 items purchased at CU10 per item on credit from Entity B. Entity B has a special offer—10% discount on all products purchased during the year of the offer, provided that more than 99 items are purchased in that year. Entity A buys five more items and the total amount payable is therefore CU900.

The debt instrument satisfies paragraph 11.9(a)(i) because the amount is fixed initially at CU950 and then later fixed at CU900. The discount does not affect the fact that amounts are fixed under the contract (that is, CU10 per item if less than 100 items are purchased and CU9 per item if 100 or more items are purchased). Therefore, provided all the conditions in 11.9(b)–(d) are met, the debt instrument is accounted for in accordance with Section 11 by both Entity A and Entity B.

Module 11—Basic Financial Instruments

Ex 26 An entity holds a ten-year treasury bond (that is, government bond) with a fixed coupon (ie the annual interest rate paid on a bond or similar instrument).

The investment in treasury bonds is a financial asset of the entity. Treasury bonds are usually quoted in an active market. However, being quoted in an active market does not automatically lead to fair value measurement. A treasury bond with a fixed coupon will usually satisfy the requirements in paragraph 11.9 and would therefore be measured at amortised cost in accordance with Section 11.

Ex 27 An entity holds a six-year debt instrument that pays a variable rate of interest specified as LIBOR plus 150 basis points, with interest payments receivable quarterly in arrears.

The debt instrument is a financial asset of the entity. It satisfies paragraph 11.9(a)(iv). Therefore, provided all the conditions in paragraph 11.9(b)–(d) are met, the debt instrument is accounted for in accordance with Section 11.

Ex 28 An entity has an overdraft facility. The bank charges interest on any amount overdrawn of EURIBOR plus 300 basis points.

The debt instrument is a financial liability of the entity. It satisfies paragraph 11.9(a)(iv). Therefore, provided all the conditions in paragraph 11.9(b)–(d) are met, the debt instrument is accounted for in accordance with Section 11.

Ex 29 Entity A issues perpetual debt instruments (for example, ‘perpetual’ bonds) to Entity B which provide the holder (Entity B) with the contractual right to receive, in perpetuity, fixed annual interest payments equal to a stated interest rate of 5% per year applied to a principal amount of CU1,000. There is no right to receive a return of principal unless the issuer defaults on interest payments. The perpetual debt instruments are classified as financial liabilities of Entity A in accordance with Section 22 *Liabilities and Equity*.

The debt instrument is a financial liability of Entity A and a financial asset of Entity B. The debt instrument satisfies paragraph 11.9(a)(i) and therefore, provided all the conditions in paragraph 11.9(b)–(d) are met, the debt instrument is accounted for in accordance with Section 11 by both entities. The fact that there is no right to receive a return of principal does not in itself mean that the requirement in paragraph 11.9(b) is not met, as in case of default or liquidation of the issuer, the holder has a right to demand the repayment of the principal. Consequently, the principal is not lost in the instrument described above.

Module 11—Basic Financial Instruments

Ex 30 Entity A issues mandatorily redeemable preference shares to Entity B. These shares have fixed annual dividend payments and a fixed maturity date. The preference shares are classified as financial liabilities of Entity A in accordance with Section 22.

The preference shares are financial liabilities of Entity A and financial assets of Entity B.

For Entity A, the financial liability (preference shares) satisfies the criteria in paragraph 11.9(a). Therefore, provided all the conditions in paragraph 11.9(b)–(d) are met, the instrument is accounted for as a debt instrument in accordance with Section 11.

For Entity B, the financial asset (investment in preference shares) satisfies the requirement in paragraph 11.8(d), provided the shares are non-puttable and non-convertible.

Ex 31 An entity has a fixed-rate mortgage loan from a bank that it used to finance the purchase of its office building. The entity has the contractual right to pay off the mortgage early and would probably do so if market interest rates fell significantly, because the entity would then be able to refinance at a lower rate.

The mortgage loan satisfies paragraph 11.9(a)—the entity pays a fixed rate of interest on the loan. There is a contractual provision that permits the entity to prepay the mortgage but, as it is not contingent on future events, paragraph 11.9(c) is satisfied. Prepayment would not cause the bank to lose its principal or any accrued interest, so the requirement in paragraph 11.9(b) will be satisfied. Assuming there are no additional conditional returns or repayment provisions (paragraph 11.9(d)), the mortgage loan satisfies paragraph 11.9.

Ex 32 An entity holds zero-coupon bonds issued by a large corporation at a discount to their par amount (ie the annual interest rate paid on a bond or similar instrument). The large corporation has the right to redeem the bond at predetermined dates earlier than the bond's contractual maturity date, at an amount equal to the bond's amortised cost at that date.

The zero-coupon bond satisfies paragraph 11.9(a), because the entity repays the principal on the bond plus a fixed rate of interest (in this case, zero). The amount of accretion of the discount is also fixed by contract. There is a contractual provision that permits the bond issuer to prepay the amount outstanding under the bond but as it is not contingent on future events paragraph 11.9(c) is satisfied. Any prepayment would not result in the entity losing its principal or any accrued interest since the prepayment must cover amortised cost at any time (that is, paragraph 11.9(b) is satisfied). Assuming there are no additional conditional returns or repayment provisions (paragraph 11.9(d)), the zero-coupon bond satisfies the requirements in paragraph 11.9.

Module 11—Basic Financial Instruments

- 11.11 Examples of financial instruments that do not satisfy the conditions in paragraph 11.9 (and are therefore within the scope of Section 12) include:
- (a) an investment in another entity's equity instruments other than non-convertible preference shares and non-puttable ordinary and preference shares (see paragraph 11.8(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 11.9(a);
 - (c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 11.9(a) is not met; and
 - (d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares instead of just with market interest rates.

Examples—financial instruments that do not satisfy paragraph 11.9

- Ex 33** To invest in a diversified portfolio of shares and bonds with only a small amount of capital, an entity purchased units (sometimes called shares) in a mutual fund.³ The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines in the fund's prospectus by buying and selling equity and debt instruments.

The investment in the mutual fund is a financial asset of the entity (that is, a contractual right to receive cash). Even though there are debt instruments in the fund, the investment does not satisfy the condition in paragraph 11.9(a), namely, that returns to Entity A (whether they are paid out as distributions or are paid on liquidation) are not fixed or variable on the basis of a single quoted or observable interest rate. Returns vary depending on the performance of the fund, that is, the performance of the debt and equity instruments within the fund. Because the investment does not satisfy all of the conditions in paragraph 11.9 and is not one of the instruments listed in paragraph 11.8(a), (c) or (d), it cannot be accounted for in accordance with Section 11. The investment in the mutual fund must be accounted for in accordance with Section 12.

- Ex 34** Entity A purchases a subsidiary from Entity B. Entity A pays CU50,000 upfront and agrees to pay a further CU50,000 to Entity B in two years' time if the subsidiary meets certain performance targets (contingent consideration). It is expected that the subsidiary will meet those targets.

Because it is a contractual obligation/right to deliver/receive cash, the contingent consideration payable/receivable is a financial liability of Entity A and a financial asset of Entity B. The contingent consideration does not satisfy the conditions in paragraph 11.9(a) or 11.9(d) because the return is conditional, that is, it is neither a

³ A mutual fund is an investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as shares, bonds and similar assets. A mutual fund is operated by investment managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors.

Module 11—Basic Financial Instruments

fixed return nor a variable rate return described in paragraph 11.9(a)(iii). As a result, the instrument falls outside the scope of Section 11.

Contingent consideration receivable (Entity B's financial asset) is accounted for in accordance with Section 12.

Contingent consideration payable (Entity A's financial liability) is outside the scope of Section 12 (see paragraph 12.3(g)). It is accounted for in accordance with Section 19 *Business Combinations and Goodwill*.

Ex 35 **An entity holds a note receivable that does not charge interest. The note gives the entity (the holder) the contractual right to receive and the issuer the contractual obligation to deliver 1,000 government bonds, rather than cash, on maturity of the note receivable.**

The note receivable is a financial asset of the entity because the entity has the contractual right to receive financial assets (in this case government bonds). Government bonds are financial assets, because their holder has the contractual right to receive cash from the government. The note is a financial liability of the note issuer.

Because the market value of the government bonds fluctuates over time, returns to the holder of the note are not fixed or variable based on a single quoted or observable interest rate. The debt instrument, therefore, does not satisfy the condition in paragraph 11.9(a). The amount repaid will equal the market value of the 1,000 government bonds at maturity. As the debt instrument (note receivable) does not satisfy all the conditions in paragraph 11.9, it cannot be accounted for in accordance with Section 11. It must be accounted for in accordance with Section 12.

Ex 36 **An entity holds a debt instrument with interest payments indexed to the price of oil. The debt instrument has a fixed payment at maturity and a fixed maturity.**

Returns to the entity vary with the price of oil rather than with only market interest rates, so the debt instrument does not satisfy the condition in paragraph 11.9(a) and cannot be accounted for in accordance with Section 11. It is accounted for in accordance with Section 12.

Ex 37 **An entity guarantees repayment of a loan by a bank to one of the entity's associates. A financial guarantee is a contractual right of the lender (bank) to receive cash from the guarantor (entity), and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower (associate) defaults.**

The guarantee provides the bank with a contingent right to cash. Because the right is contingent on a future unknown event, the condition in paragraph 11.9(d) is not satisfied. Also, the loan amount is neither fixed nor variable on the basis of a single quoted or observable interest rate, so the conditions in paragraph 11.9(a) are not met either. The entity's financial liability does not satisfy all the conditions in paragraph 11.9, therefore, the entity cannot account for the guarantee in accordance with Section 11. Applying the non-mandatory guidance in SMEIG Q&A 2017/01, the entity must account for the guarantee in accordance with Section 12.

Module 11—Basic Financial Instruments

Ex 38 A customer takes legal action against an entity for damage the customer states was caused by one of the entity's products. The entity takes out a three-year bank loan to finance the legal fees. There is a contractual provision in the loan contract that if the entity wins the case, the entity may repay the loan early. If the entity is unsuccessful, it cannot repay the loan early.

The loan does not satisfy the conditions in paragraph 11.9(c) because the contractual provision that permits the entity to repay the loan before maturity is contingent on the outcome of the case (a future event). Therefore, the debt instrument (the loan) does not satisfy all the conditions in paragraph 11.9 and consequently cannot be accounted for in accordance with Section 11. It must be accounted for in accordance with Section 12.

Ex 39 An entity buys a fixed rate interest-only strip on a bond (that is, the entity buys the stream of future interest payments on a fixed rate bond). The strip was created in a securitisation and is subject to prepayment risk (that is, the risk that all or part of the principal of a loan will be paid before the scheduled maturity). The entity therefore obtains the right to receive the interest cash flows, but not the principal cash flows from the debt instrument.

For a debt instrument to satisfy the condition in paragraph 11.9(b) there must be no contractual provision that could, by its terms, result in the holder losing the principal amount. In this case the principal amount is the original investment by the entity. If the issuer of the bond (creditor) chooses to settle the bond early, the entity may not recover its investment since no interest payments will be incurred after settlement of the principal. Since the entity may lose some or all of its original investment (as it will not receive the interest payments it paid for) the fixed rate interest-only strip does not satisfy the conditions in paragraph 11.9, so the debt instrument cannot be accounted for in accordance with Section 11. It must be accounted for in accordance with Section 12.

Ex 40 Entity A has an investment in shares in Entity B. Embedded within the shares is a put option allowing Entity A to sell the shares back to Entity B for the higher of the market value of the shares and an amount equal to the initial investment made by Entity A plus compounded interest based on market rates. Therefore, Entity A will receive a rate of return that is at least equal to the return on a debt instrument. The option is exercisable three years after Entity A acquires the shares.

Entity A's perspective: The investment in Entity B's shares (financial asset) does not satisfy the condition in paragraph 11.8(d)—the shares are puttable.

If this instrument is considered to meet the definition of a debt instrument in substance, there being a minimal return equal to that on a debt instrument, the instrument would not satisfy paragraph 11.9 as returns may be equal to the market value of the shares and hence are not fixed or variable on the basis of a single quoted or observable interest rate.

Therefore, Entity A's investment in shares cannot be accounted for in accordance with Section 11. It must be accounted for in accordance with Section 12.

Module 11—Basic Financial Instruments

Entity B's perspective: Entity B applies Section 22 *Liabilities and Equity* to determine whether its own shares should be classified as equity, a compound instrument or a financial liability within the scope of Section 11 or Section 12.

Initial recognition of financial assets and liabilities

11.12 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.

Notes

Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

The following arrangements are not recognised as financial assets and liabilities:

- Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.
- Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered.

Module 11—Basic Financial Instruments

Initial measurement

11.13 When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price (including **transaction costs** except in the initial measurement of financial assets and liabilities that are subsequently measured at fair value through profit or loss) unless the arrangement constitutes, in effect, a financing transaction for either the entity (for a financial liability) or the counterparty (for a financial asset) to the arrangement. An arrangement constitutes a financing transaction if payment is deferred beyond normal business terms, for example, providing interest-free credit to a buyer for the sale of goods, or is financed at a rate of interest that is not a market rate, for example, an interest-free or below market interest rate loan made to an employee. If the arrangement constitutes a financing transaction, the entity shall measure the financial asset or financial liability at the **present value** of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition.

Examples—financial assets

- 1 For a long-term loan made to another entity, a receivable is recognised at the present value of cash receivable (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 the undiscounted amount of 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 as 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 (for example, 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.

Module 11—Basic Financial Instruments

Notes

When is an entity required to use present value?

In most cases financial instruments are measured, at initial recognition, at their transaction price. Exceptions to this rule that require calculation of a present value are set out below.

Sale and purchase transactions

In nearly all cases financial instruments will, on initial recognition, be measured at their transaction price. However, if a purchase or sale agreement contains an implicit financing transaction (for example, allows 'interest-free' deferred payment), the entity must initially measure the financial asset or financial liability at the present value of the transaction price (that is, the present value of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition). The similar debt instrument should be similar as to currency of transaction, term of financing, credit rating of borrower, interest rate that the borrower would normally pay on such a financing transaction and other factors.

Most financing transactions implicit in sale or purchase transactions will be made at a market rate of interest (that is, the transaction can be said to take place at arm's length), especially if they are entered into by unrelated parties, each acting in its own best interest. In such a case, the cash sale price will normally approximate the present value of the future payments discounted at the appropriate market rate (see example 46). The cash sale price is the amount of cash that would need to be paid to acquire/sell an asset if the cash is paid upfront, on the date of the sale/purchase.

Where payment of the sale and purchase transactions takes place under normal business terms (which could, for example, be 30 or 60 days' credit terms depending on the practice in that jurisdiction and industry), Section 11 allows the transaction price to be used (often the original invoice amount) as a practical simplification because the effect of discounting is unlikely to be material. This is usually appropriate for short-term trade receivables and payables.

Other debt instruments

Where a loan is made at a market rate for a similar loan, the entity shall initially measure the debt instrument at the transaction price (often the cash exchanged upfront). An example of a transaction that may be financed at a rate of interest that is not a market rate is a loan from a parent entity to a subsidiary at a lower interest rate than an unrelated party would charge on the same loan. By providing a reduced rate of interest to its subsidiary, the parent is providing its subsidiary with implicit financing, in addition to the underlying loan. Consequently, the transaction price does not approximate the present value of the future payments discounted at the appropriate market rate. When a loan is not made at a market rate for a similar loan, the entity initially recognises the loan at the present value of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition.

If a financial liability is payable in full on demand (for example, as may be the case if there is no set repayment date) it should not be discounted (that is, it is recognised at

Module 11—Basic Financial Instruments

the full amount payable on demand (see example 53)). On subsequent measurement it will continue to be recognised at the full amount outstanding with no discounting.

Transaction costs

What are transaction costs?

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument (see Glossary). Transaction costs include fees and commissions paid to agents (including employees acting as selling agents, if such costs are incremental), advisers, brokers and dealers; levies by regulatory agencies and securities exchanges; and transfer taxes and duties. Fees included in transaction costs include those that are an integral part of generating an involvement with the resulting financial instrument (for example, negotiating the terms of the instrument, and preparing and processing documents).

Transaction costs do not include debt premiums or discounts, financing costs or internal administrative costs.

How to account for transaction costs

Transaction costs attributable to the acquisition of a financial instrument which will be measured, after initial recognition, at amortised cost or cost (see paragraph 11.14 (a), (b) and (c)(ii)) are included in the amount recognised on initial recognition of the financial instrument. For financial assets, incremental costs that are directly attributable to the acquisition of the asset are added in arriving at the amount recognised on initial recognition. For financial liabilities, directly related costs of issuing debt are deducted in arriving at the amount of debt recognised on initial recognition. Transaction costs will therefore be included in the calculation of amortised cost using the effective interest method and consequently are recognised in profit or loss over the life of the instrument.

The journal entry for transaction costs that are paid in cash and relate to financial instruments to be measured at amortised cost is:

Dr Financial asset/financial liability

Cr Cash

For financial instruments that are measured at fair value through profit or loss after initial recognition (see paragraph 11.14(c)(i)), transaction costs are recognised as expenses when they are incurred. In other words, transaction costs are not taken into account when determining the amount to recognised initially. The journal entry for transaction costs that are paid in cash and relate to financial instruments to be subsequently measured at fair value is:

Dr Profit or loss

Cr Cash

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the initial or subsequent measurement of the financial instruments.

Module 11—Basic Financial Instruments

If the acquisition, issue or disposal of a financial asset or financial liability is abandoned, any transaction costs related to that transaction are recognised as an expense.

Examples—financial assets

Ex 41 An entity incurred CU10 broker transaction fees to buy 50 non-puttable ordinary shares in a listed company on the market for cash of CU500.

The entity initially recognises an investment in equity instruments at the price paid (that is, CU500). Because the financial instruments will, after initial recognition, be measured at fair value (see paragraph 11.14(c)(ii)) the transaction costs are not included in their initial measurement.

The journal entries on initial recognition are:

Dr	Investment in equity instruments (financial asset)	CU500	
Dr	Profit or loss (transaction costs)	CU10	
	Cr Cash (financial asset)		CU510

To recognise the acquisition of non-puttable ordinary shares of a listed company and its transaction costs.

Ex 42 An entity incurred CU10 broker transaction fees to buy 50 non-puttable ordinary shares in an unlisted company for cash of CU500. The fair value of the shares cannot be measured reliably without undue cost or effort on an ongoing basis and therefore the investment is measured at cost less impairment in accordance with paragraph 11.14(c).

The entity initially recognises an investment in equity instruments at CU510. Because the financial instruments will, after initial recognition, be measured at cost less impairment the transaction costs are included in their initial measurement.

The journal entries on initial recognition are:

Dr	Investment in equity instruments (financial asset)	CU510	
	Cr Cash (financial asset)		CU510

To recognise the acquisition of non-puttable ordinary shares of an unlisted company whose fair value cannot be measured reliably without undue cost or effort.

Ex 43 An entity provides services to a customer and charges the customer CU200 with payment due within 60 days. Payment terms of 30–90 days are normal in the industry.

The entity initially recognises a trade receivable at CU200 (that is, the undiscounted amount of cash receivable)—the transaction took place under normal business terms with no implicit financing transaction therefore discounting is not required. The journal entries on initial recognition are:

Dr	Trade receivable (financial asset)	CU200	
	Cr Profit or loss—revenue		CU200

To recognise the revenue from the rendering of services on credit.

Module 11—Basic Financial Instruments

Ex 44 An entity deposits CU20,000 into a 120-day notice deposit account with a bank. The entity will receive fixed interest at 1.644% for the 120-day period (that is, equivalent to 5% per year ignoring compounding), payable at the end of the deposit period. The market rate for this type of deposit with the bank is 1.644% per 120-day period.

As the deposit with the bank is at a market interest rate for a similar loan it must be recognised at the transaction price of CU20,000 (see calculation below). The journal entries on initial recognition are:

Dr	Bank deposit (financial asset)	CU20,000	
	Cr Cash (financial asset)		CU20,000

To recognise the bank deposit.

Ex 45 The facts are the same as in example 44. However, in this example, the entity had to pay the bank an upfront administration fee of CU50 to cover paperwork etc.

The deposit is recognised at CU20,050, which is equal to the CU20,000 plus the transaction cost. The journal entries on initial recognition are:

Dr	Bank deposit (financial asset)	CU20,000	
	Cr Cash (financial asset)		CU20,000

To recognise the bank deposit.

Dr	Bank deposit (financial asset)	CU50	
	Cr Cash (financial asset)		CU50

To recognise the transaction fee.

Ex 46 On 1 January 20X2 a machine manufacturing entity sells a customer a machine for CU2,000 with payment in two years' time. The current cash sale price for that item if customers pay on delivery is CU1,650.

This sale transaction includes an implicit financing transaction (two-year loan). A receivable is recognised at the current cash sale price of the item (see the third example of financial assets in paragraph 11.13). The journal entries on initial recognition are:

Dr	Trade receivable (financial asset)	CU1,650	
	Cr Profit or loss (revenue)		CU1,650

To recognise the revenue from the sale of goods on credit (including an implicit financing transaction).

The difference between the current sale price (CU1,650) and the consideration receivable (CU2,000) will be recognised as interest revenue using the effective interest method—it represents a financing transaction (see example 70).

Module 11—Basic Financial Instruments

Ex 47 The facts are the same as in example 46. However, in this example, the current cash sale price for the machine is unknown. The market rate of interest for a two-year loan to the customer would be 10% per year.

A receivable is recognised at the present value of the amount receivable which is $CU2,000 \div (1.1)^2 = CU1,652.89$.

If the current cash sale price is not known, it may be estimated as the present value of the cash receivable discounted using the market rate of interest for a similar debt instrument (see the third example of financial assets in paragraph 11.13).

Ex 48 An entity grants an interest-free loan of CU500 to an employee for a period of three years. The market rate of interest for similar loans is 5% per year (that is, the market rate of interest for a three-year loan to this individual).

As the loan is not at a market interest rate for a similar loan, it is not recorded at the transaction price of CU500. Instead the entity measures the loan receivable at the present value of the future cash inflows discounted at a market rate of interest for a similar loan.

The present value of the loan receivable (financial asset) discounted at 5% per year is $CU500 \div (1.05)^3 = CU431.92$. Therefore, CU431.92 is recorded on initial measurement of the loan receivable. This amount will accrete to CU500 over the three-year term using the effective interest method (see example 66).

The difference between CU500 and CU431.92 (that is, CU68.08 is accounted for as employee remuneration in accordance with Section 28 *Employee Benefits*). In accordance with Section 28, the CU68.08 will either be recognised immediately or deferred depending on whether there are further service conditions attached. For example, if the entity intends the loan to be additional compensation, and the employee must repay the loan if the employee departs before three years, the CU68.08 would be recognised as additional compensation using the effective interest method.

The journal entries on initial recognition are:

Dr	Loan receivable (financial asset)	CU431.92	
Dr	Profit or loss (employee benefits expense) or Employee benefits paid in advance (asset)	CU68.08	
	Cr Cash (financial asset)		CU500

To recognise the loan granted to an employee.

Module 11—Basic Financial Instruments

Ex 49 The facts are the same as in example 48. However, in this example, the entity grants the interest-free loan of CU500 to a major customer instead of an employee for a period of three years. Assume the market rate of interest for a similar loan to this customer is also 5% per year. Entity A expects to receive implicit benefits from making the loan, such as customer loyalty and preferential placement of products in the customer’s shops, but the terms of the loan do not require the customer to take any specific actions.

The present value of the loan receivable (financial asset) discounted at 5% is $CU500 \div (1.05)^3 = CU431.92$. Therefore, CU431.92 is recorded on initial measurement of the loan receivable. This amount will accrete to CU500 over the three-year term using the effective interest method (see example 66).

The difference between the CU500 and the CU431.92 of CU68.08 will probably need to be recognised as an expense immediately unless it meets the definition of an intangible asset under Section 18 *Intangible Assets other than Goodwill*. Since the amount relates only to uncertain benefits, it is unlikely that it will meet the criteria for recognition as an asset under any other sections. It does not meet the definition of a financial asset as there is no contractual right to receive cash or other financial assets. Even if the customer intends to return additional money to the entity (for example, by sharing a portion of its profits, there is no contractual requirement to do this).

The journal entries on initial recognition are:

Dr	Loan receivable (financial asset)	CU431.92	
Dr	Profit or loss—discount to customer (expense) or Intangible asset (asset)	CU68.08	
	Cr Cash (financial asset)		CU500

To recognise the loan granted to a customer.

Ex 50 On 1 January 20X0 an entity acquires a zero-coupon bond in the market for CU98 in an arm’s length transaction. The entity incurs transaction fees of CU2. The bond will be redeemed at CU126 on 31 December 20X4.

Since it is clear the purchase of the zero-coupon bond took place in an arm’s length transaction in the market, interest will be payable by the issuer of the bond at a market rate (note, although the bond is zero coupon, interest is payable via the accretion of the bond from CU98 to CU126). Therefore, the bond should be recorded at the transaction price. As the bond will be measured at amortised cost, the transaction costs are included in the initial measurement of the bond.

The journal entries on initial recognition are:

Dr	Bond (financial asset)	CU100	
	Cr Cash (financial asset)		CU100

To recognise the investment in bonds.

The CU100 will accrete to CU126 over the four-year period (see example 71).

Module 11—Basic Financial Instruments

Examples—financial liabilities

Ex 51 An entity buys goods from a manufacturer for CU400 with 120 days' interest-free credit, the normal business terms in the industry.

The entity initially recognises a trade payable at CU400 (that is, the undiscounted amount of cash payable). The transaction takes place on normal business terms with no implicit financing transaction, so discounting is not required. The journal entries on initial recognition are:

Dr	Inventories (asset)	CU400	
	Cr Trade payable (financial liability)		CU400

To recognise the acquisition of inventory on credit.

Ex 52 An entity starts renting an office building for CU1,000 a month on 1 November 20X1. At its year-end (31 December 20X1) the entity has not yet paid any rent. Landlords in the nearby area allow tenants to pay rentals quarterly in arrears.

The entity owes CU2,000 for use of the property during November and December. The short-term credit provided by the landlord is normal in the industry and there is no implicit financing transaction. The journal entries to recognise the first two months' rentals are:

Dr	Profit or loss (rental expense)	CU2,000	
	Cr Rental payable (financial liability)		CU2,000

To recognise the accrual of rental expense.

The amount would be discounted if payment was deferred beyond normal business terms and, therefore, in effect, contained an implicit financing transaction.

Ex 53 An entity utilises CU1,500 of an interest-free overdraft facility it has with a bank to pay an amount outstanding to a supplier. The overdraft is repayable on demand. The bank has not indicated that it will request repayment in the near future. The entity does not expect to pay off the amount during the year.

The entity will recognise a financial liability for the overdrawn amount of CU1,500. It is not discounted at a market rate as it is repayable on demand so it must be recognised at the 'face' amount.

The journal entries on initial recognition are:

Dr	Trade payable (financial liability)	CU1,500	
	Cr Overdraft (financial liability)		CU1,500

To recognise the settlement of the trade payable.

Module 11—Basic Financial Instruments

Ex 54 A bank provides an entity with a four-year loan of CU5,000 on normal market terms, including charging interest at a fixed rate of 8% per year. Interest is payable at the end of each year. The figure of 8% is considered the market rate for similar four-year fixed-interest loans with interest paid annually in arrears.

Since interest is payable at a market rate for that type of loan, the entity initially records the loan at the transaction price (that is, CU5,000). The journal entries on initial recognition are:

Dr	Cash (financial asset)	CU5,000	
	Cr Loan (financial liability)		CU5,000

To recognise the bank loan.

Note: Since interest on the loan is charged at the market rate, the present value of cash payable to the bank will be equal to the transaction price of CU5,000 (see calculation below).

Time	Cash payable (a)	Discount factor (8%) (b)	Present value (a) x (b)
Year 1	400	0.9259	370.37
Year 2	400	0.8573	342.94
Year 3	400	0.7938	317.53
Year 4	400	0.7350	294.01
Year 4	5,000	0.7350	3,675.15
			5,000.00

Ex 55 The facts are the same as in example 54. However, in this example, the entity obtains the loan after taking advice from a specialist loans broker. The broker charges the entity CU100.

The loan is initially recorded at the transaction price less the broker fees (that is, CU4,900). The journal entries are:

Loan

Dr	Cash (financial asset)	CU5,000	
	Cr Loan (financial liability)		CU5,000

To recognise the loan.

Transaction fee

Dr	Loan (financial liability)	CU100	
	Cr Cash (financial asset)		CU100

To recognise the borrowing costs.

Note: The amount recognised on initial recognition (CU4,900) will accrete to CU5,000 over the term using the effective interest method with additional interest expense recognised totalling CU100 over the term of the loan (see example 73).

Module 11—Basic Financial Instruments

Ex 56 A bank provides an entity with a four-year loan for CU5,000 under normal market terms for that type of loan, including charging interest at a variable rate of interest specified as LIBOR plus 250 basis points, with interest payments receivable annually in arrears.

Since interest is payable at a market rate for that type of loan, the loan is recorded by the entity at the transaction price (that is, CU5,000). The journal entries are:

Dr	Cash (financial asset)	CU5,000	
	Cr Loan (financial liability)		CU5,000

To recognise the bank loan.

Note: If transaction fees of CU50 were incurred on getting the loan, it would be recorded at CU4,950. The journal entry for the transaction fees would be:

Transaction fee

Dr	Loan (financial liability)	CU50	
	Cr Cash (financial asset)		CU50

To recognise the borrowing costs.

Note: The CU50 transaction fees would be amortised over the period of the loan through the effective interest method.

Ex 57 A bank provides an entity with a five-year loan of CU5,000. The bank charges the entity interest at 10% per year with interest paid at the end of each year. The market rate for similar five-year fixed-interest loans with interest paid yearly in arrears is 8%. The bank transferred to the entity an additional amount (an upfront fee) of CU400, which is considered to compensate the entity for paying a higher rate of interest.

Since the CU400 is considered to compensate the entity for paying interest above the market rate, the entity is effectively paying a normal market rate to borrow CU5,400. Therefore, the loan is recorded at the transaction amount, which is the face value of the loan plus the upfront cash payment (that is, CU5,400). The journal entries on initial recognition are as follows:

Loan

Dr	Cash (financial asset)	CU5,000	
	Cr Loan (financial liability)		CU5,000

To recognise the bank loan.

Upfront compensation payment

Dr	Cash (financial asset)	CU400	
	Cr Loan (financial liability)		CU400

To recognise the upfront compensation received from the bank.

The journal entries on subsequent recognition are illustrated in example 75.

Module 11—Basic Financial Instruments

CU5,400 is equal to the present value of the loan (see calculation below):

<i>Time</i>	<i>Cash payable</i> (a)	<i>Discount factor (8%)</i> (b)	<i>Present value</i> (a)x(b)
Year 1	500	0.9259	462.96
Year 2	500	0.8573	428.67
Year 3	500	0.7938	396.92
Year 4	500	0.7350	367.51
Year 5	500	0.6806	340.29
Year 5	5,000	0.6806	3402.92
			5,399.27

The difference between CU5,399.27 (in the table) and CU5,400 is due to rounding.

Ex 58 On 1 January 20X0 Entity A issues a debt instrument for a price of CU1,250. The principal amount is CU1,250 and the repayment date is fixed—31 December 20X4. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6% in 20X0 (CU75), 8% in 20X1 (CU100), 10% in 20X2 (CU125), 12% in 20X3 (CU150) and 16.4% in 20X4 (CU205). The entity structured the payments in this manner to manage its cash flows. The market rate of interest for similar loans is 10% per year.

It is not clear whether the interest rate in the debt instrument is priced at a market interest rate for a similar debt instrument. The present value of the future payments discounted at the market rate is CU1,250.62. This is approximately equal to the transaction price, as would be expected for a loan made between two unrelated parties (that is, at arm's length). Therefore, on initial recognition the loan is measured at CU1,250.

The journal entries are:

Initial recognition

Dr	Cash (financial asset)	CU1,250	
	Cr Loan (financial liability)		CU1,250

To recognise the contractual obligations for the debt instrument issued by the entity.

The entries to make on subsequent measurement are set out in example 76.

See calculation of the present value at the market rate of 10% below:

<i>Time</i>	<i>Cash payable</i> (a)	<i>Discount factor (10%)</i> (b)	<i>Present value</i> (a)x(b)
20X0	75	0.9091	68.18
20X1	100	0.8264	82.64
20X2	125	0.7513	93.91
20X3	150	0.6830	102.45
20X4	1,455 (ie 205 + 1,250)	0.6209	903.44
		Total	1,250.62

The immaterial difference between CU1,250.62 (in the table above) and CU1,250 is due to rounding.

Module 11—Basic Financial Instruments

Subsequent measurement

- 11.14 At the end of each **reporting period**, an entity shall measure financial instruments as follows, without any deduction for transaction costs the entity may incur on sale or other disposal:
- (a) debt instruments that meet the conditions in paragraph 11.8(b) shall be measured at **amortised cost** using the **effective interest method**. Paragraphs 11.15–11.20 provide guidance on determining amortised cost using the effective interest method. Debt instruments 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 (ie net of impairment—see paragraphs 11.21–11.26) unless the arrangement constitutes, in effect, a financing transaction (see paragraph 11.13).
 - (b) commitments to receive a loan that meet the conditions in paragraph 11.8(c) shall be measured at cost (which sometimes is nil) less impairment.
 - (c) investments in non-convertible preference shares and non-puttable ordinary or preference shares shall be measured as follows (paragraphs 11.27–11.32 provide guidance on fair value):
 - (i) if the shares are publicly traded or their fair value can otherwise be measured reliably without undue cost or effort, the investment shall be measured at fair value with changes in fair value recognised in profit or loss; and
 - (ii) all other such investments shall be measured at cost less impairment.
- Impairment or uncollectability must be assessed for financial assets in (a), (b) and (c)(ii) above. Paragraphs 11.21–11.26 provide guidance.

Examples—financial assets

Ex 59 An entity bought 50 non-puttable ordinary shares during the year in a listed company on the market for cash of CU500 and incurred broker transaction fees of CU10. At year-end, the shares are quoted at CU11 per share.

The entity initially recognised its investment in equity instruments at CU500 (see example 41). Because the shares are publicly traded, the entity must, after initial recognition, measure the investment at fair value and it must recognise changes in fair value in profit or loss (see paragraph 11.14(c)(i)).

Therefore, the journal entries are:

Subsequent measurement

Dr	Investment in equity instruments (financial asset)	CU50	
	Cr Profit or loss—gain on investment in equity instruments		CU50

To recognise the change in the fair value of the investment in the period of the change.

Module 11—Basic Financial Instruments

Ex 60 An entity bought 50 non-puttable ordinary shares during the year in an unlisted company for cash of CU500, incurring broker transaction fees of CU10. The shares are not publicly traded and the fair value of the shares cannot otherwise be measured reliably without undue cost or effort.

The entity initially recognised the investment in equity instruments at CU510 (see example 42).

On subsequent measurement, at year-end, because fair value cannot be measured reliably without undue cost or effort, the entity must measure the investment at cost less accumulated impairment (see paragraph 11.14(c)(ii)). Assuming there is no indication that the investment is impaired, the investment will be measured at CU510 (that is, the amount at which it was measured at initial recognition, CU500 paid for the shares + CU10 transaction fees).

Ex 61 On 15 December 20X1 an entity provided services to a customer and charged the customer CU200 with payment due within 60 days. At the entity's financial year-end (31 December 20X1) the customer has not yet paid the amount due.

The entity initially recognised a trade receivable at CU200 (see example 43).

The trade receivable is a current asset and there is no hidden financing transaction. Therefore, assuming the customer is expected to pay the full amount shortly after year-end (hence, there is no impairment), on subsequent measurement at 31 December 20X1 the trade receivable would continue to be measured at the undiscounted amount of the cash expected to be received (that is, CU200).

Examples—financial liabilities

Ex 62 An entity buys goods from a manufacturer for CU400 on 1 November 20X2 with 120 days' interest-free credit, which are normal business terms in the industry. At the entity's financial year-end (31 December 20X2) it has not yet paid the manufacturer.

On 1 November 20X2 the entity initially recognised the trade payable at CU400 (see example 51).

The trade payable is a current liability and the transaction took place under normal business terms with no hidden financing transaction. Therefore, on subsequent measurement at 31 December 20X2 the trade payable continues to be measured at the undiscounted amount of the cash expected to be paid (that is, CU400).

Ex 63 An entity has an interest-free overdraft facility with a bank. The overdraft is repayable on demand by the bank. However, the bank has not indicated that it will request repayment in the near future. At the entity's financial year-end CU2,000 is outstanding on the overdraft. The entity does not expect to pay off the amount during the year.

The entity will recognise a financial liability for the overdrawn amount of CU2,000 in its statement of financial position. It is not discounted at market rate as it is repayable on demand.

Module 11—Basic Financial Instruments

Amortised cost and effective interest method

- 11.15 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 uncollectability.

Financial assets and financial liabilities that have no stated interest rate, that do not relate to an arrangement that constitutes a financing transaction and that are classified as current assets or current liabilities are initially measured at an undiscounted amount in accordance with paragraph 11.13. Consequently, (c) does not apply to them.

- 11.16 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 on the basis of 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; and
 - (b) the interest expense (income) in a period equals the carrying amount of the financial liability (asset) at the beginning of a period multiplied by the effective interest rate for the period.

Notes

If transactions are financed at a market rate of interest in an arm's length transaction, the transaction price will usually approximate the present value of the future payments discounted at a market rate. For financial instruments financed at a market rate of interest and hence recorded at the transaction price, the effective rate of interest on initial recognition will usually be the market rate (see examples 66 and 72). However, if transaction costs and other premiums or discounts are involved, this will often mean the effective interest rate is not equal to the market rate of an instrument that does not have these features (see example 73).

For financial liabilities, if a creditor may demand repayment at a certain date, an entity cannot assume a term longer than the length of time up to that date. For example, if a loan is repayable on demand or on a certain date in the future the entity should assume repayment takes place on that date for the purposes of the amortised cost calculation.

Module 11—Basic Financial Instruments

11.17 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) and known credit losses that have been incurred, but it shall not consider possible future credit losses not yet incurred.

Example—amortisation period

Ex 64 An entity provides its associate with a five-year loan at 5% interest payable annually in arrears. The contract specifies that the associate has the option to prepay the instrument and that no penalty will be charged for prepayment. The prepayment option is not contingent on future events.

If at inception the entity expects the associate not to prepay the loan, the amortisation period is equal to five years.

If at inception the entity expects the associate to prepay the loan after two years, the amortisation period is two years. In other words, the loan will be treated as if it is a two-year loan when determining the effective interest rate (that is, only two years of interest payments at 5% and repayment of principal at the end of the second year).

11.18 When calculating the effective interest rate, an entity shall amortise any related fees, finance charges paid or received (such as 'points'), 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, finance charges paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, finance charges paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date.

Notes

If a premium or discount on a variable rate instrument (for example, those instruments satisfying the conditions in paragraph 11.9(a)(iii) or (iv)) reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the variable interest rate was reset to market rates, it will be amortised to the next date when the variable interest is once again reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (that is, interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the variable rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

It is usually appropriate to amortise transaction costs that are incurred in setting up or acquiring a variable rate instrument over the instrument's expected life since such costs are not subject to repricing or related to any particular term of the loan.

Refer also to notes and examples under paragraph 11.13 for discussion of transaction costs.

Module 11—Basic Financial Instruments

Example—amortisation period

Ex 65 A bank provides an entity with a five-year loan for CU1,000. The first two years of the loan are interest-free. After that, interest is payable monthly in arrears at the variable quoted market interest rate in the jurisdiction as quoted at the start of each month. The entity is charged an upfront fee of CU70.

The fee of CU70 will be amortised over the first two years (not the entire five years). This is because the interest will be repriced to the market rate after two years.

The loan may be considered to be at a fixed rate for two years, hence the interest of CU70 is allocated using the effective interest method. One way of doing this is as follows:

	<i>Carrying amount at start of period</i>	<i>Interest income at 3.695%^(a)</i>	<i>Carrying amount at end of period</i>
Year 1	930.00	34.37	964.37
Year 2	964.37	35.63	1,000.00

(a) The effective interest rate of 3.695% is the rate that accretes CU930 to CU1,000 over the two-year period. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note below paragraph 11.20).

Note: The carrying amount of the loan is CU930 on initial recognition (CU1,000 less upfront interest paid of CU70). Interest expense is recognised to accrete the loan from CU930 to CU1,000 over the two-year period.

- 11.19 For variable rate financial assets and variable rate financial liabilities, periodic re-estimation of cash flows to reflect changes in market rates of interest alters the effective interest rate. If a variable rate financial asset or variable 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.
- 11.20 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 shall recalculate the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The entity shall recognise the adjustment as income or expense in profit or loss at the date of the revision.

Module 11—Basic Financial Instruments

Notes

The cash flows that are discounted to arrive at the effective interest rate are the contractual cash flows that management expects to occur over the instrument's expected life. If actual cash flows differ from expectation, the entity will need to revise its amortised cost calculations. If an entity did not revise its amortised cost calculations a balance may remain on the receivable/payable after the last cash flow has taken place or the receivable/payable may have a carrying amount of nil even though there are still cash flows remaining that should continue to be recognised.

For fixed interest instruments (for example, those instruments satisfying the conditions in paragraph 11.9(a)(i) or (ii)) when cash flows are re-estimated the effective interest rate generally stays constant over the instrument's term and so is not updated. In contrast, for variable rate financial assets and variable rate financial liabilities (for example, those instruments satisfying the conditions in paragraph 11.9(a)(iii) or (iv)), when cash flows are re-estimated to reflect movements in market rates of interest, the effective interest rate is updated. This is because for variable rate instruments it would be inappropriate to determine at inception a single fixed rate to discount estimated future cash flows as varying interest receipts/payments are a contractual term of a variable rate instrument.

If a variable rate financial asset or variable rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability. This is because the effective interest rate at any date will normally approximate the market rate at that date (see examples 77 and 78).

The re-estimation of future cash flows for reasons other than changes in market rates or financial instruments not being variable rate instruments will normally result in a change in the carrying amount, since the revised estimated cash flows are discounted at the instrument's original effective interest rate. The adjustment is recognised in profit or loss as income or expense (see example 79).

Module 11—Basic Financial Instruments

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

On 1 January 20X0, an entity acquires a bond for CU900, incurring transaction costs of CU50. Interest of CU40 is receivable annually, in arrears, over the next five years (31 December 20X0–31 December 20X4). The bond has a mandatory redemption of CU1,100 on 31 December 20X4.

Year	Carrying amount at beginning of period	Interest income at 6.9584%*	Cash inflow	Carrying amount at end of period
	CU	CU	CU	CU
20X0	950.00	66.11	(40.00)	976.11
20X1	976.11	67.92	(40.00)	1,004.03
20X2	1,004.03	69.86	(40.00)	1,033.89
20X3	1,033.89	71.94	(40.00)	1,065.83
20X4	1,065.83	74.17	(40.00)	1,100.00
			(1,100.00)	0

* The effective interest rate of 6.9584% is the rate that discounts the expected cash flows on the bond to the initial carrying amount:

$$40 \div (1.069584)^1 + 40 \div (1.069584)^2 + 40 \div (1.069584)^3 + 40 \div (1.069584)^4 + 1,140 \div (1.069584)^5 = 950$$

Notes

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 at initial recognition (see paragraph 11.16). In other words, the carrying amount on initial recognition less the estimated future cash payments or receipts through the expected life of the financial instrument discounted at the effective interest rate = 0.

The effective interest rate can be determined using the ‘Goal Seek’ function in an Excel spreadsheet. This has been illustrated below using the example of a five-year bond. Additional help can be found on using the Goal Seek function in the help section of Excel.

Module 11—Basic Financial Instruments

How to use the Goal Seek function?

Set out the table as shown below in the Excel spreadsheet. The items in shaded boxes are formulas. The other numbers are taken from the example above which is taken from the *IFRS for SMEs* Standard.

	A	B	C	D	E
1		Effective rate	Z%		
2					
3	Year	(α) Carrying amount at beginning of period	(β) Interest income at Z% ($\beta = \alpha \times Z\%$)	(γ) Cash inflow	(δ) Carrying amount at end of period ($\delta = \alpha + \beta + \gamma$)
4		CU	CU	CU	CU
5	20X0	950	=B5*C1	-40	=B5+C5+D5
6	20X1	=E5	=B6*C1	-40	=B6+C6+D6
7	20X2	=E6	=B7*C1	-40	=B7+C7+D7
8	20X3	=E7	=B8*C1	-40	=B8+C8+D8
9	20X4	=E8	=B9*C1	-1140	=B9+C9+D9

The objective is to set the carrying amount at 31 December 20X4 (cell E9) to be equal to zero by changing cell C1. This can be done using the Goal Seek function. Cell E9 will be equal to zero if the effective interest rate is in cell C1. This uses the fact that:

Carrying amount on initial recognition less estimated future cash receipts through the expected life of the financial instrument discounted at the effective interest rate = 0.

Note: Before using the Goal Seek function, make sure cell C1 is empty or the Goal Seek function will not work. The 'Z%' is currently input in cell C1 for illustration purposes only.

Steps in using Goal Seek:

- On the Data menu, click 'What-If Analysis' and choose 'Goal Seek...'. A small box labelled Goal Seek will appear on the screen, containing three input boxes. These are labelled 'Set cell', 'To value' and 'By changing cell'.
- In the 'Set cell' box, enter the reference for the cell that contains the carrying amount at the end of 20X4 (that is, cell E9).
- In the 'To value' box, type 0.
- In the 'By changing cell' box, enter the reference of the cell which has 'Z%' in it (that is, C1 in the table).
- Press enter.
- The value in cell C1 should have changed to 0.0695845. This is the effective interest rate.

Module 11—Basic Financial Instruments

After clicking 'Enter' the table should look like this:

	Effective rate	0.0695845		
Year	(α) Carrying amount at beginning of period CU	(β) Interest income at Z% ($\beta = \alpha \times Z\%$) CU	(γ) Cash inflow CU	(δ) Carrying amount at end of period ($\delta = \alpha + \beta + \gamma$) CU
20X0	950	66.11	-40	976.11
20X1	976.11	67.92	-40	1004.03
20X2	1004.03	69.86	-40	1033.89
20X3	1033.89	71.94	-40	1065.83
20X4	1065.83	74.17	-1140	0

Alternatively, the effective interest rate can be calculated using the 'Internal Rate of Return' (IRR) formula using Excel spreadsheet. The formula is presented in a shaded box.

	A	B
1		Cash flows
2		950
3		-40
4		-40
5		-40
6		-40
7		-1140
8		
9	Effective rate	=IRR (B2:B7,)

In cell B9 'B2:B7' identifies the cash flow values presented in cells B2 to B7. The comma indicates that we have not estimated the IRR.

Module 11—Basic Financial Instruments

Examples—financial assets

Ex 66 On 1 January 20X1 an entity granted an interest-free loan of CU500 to an employee for a period of three years. The market rate of interest for similar loans is 5% (that is, the market rate of interest for a loan to this individual). The entity has a 31 December financial year-end.

On initial recognition the loan receivable was recorded by the entity at CU431.92 (see example 48).

The journal entry in 20X1, excluding those on initial recognition is:

Dr	Loan receivable (financial asset)	CU21.59	
	Cr Profit or loss—interest income		CU21.59

To recognise interest income on an employee-loan.

The effective interest rate is 5% per year (see calculation below):

Time	Carrying amount at 1 January	Interest at 5% ^(a)	Cash inflow	Carrying amount at 31 December
20X1	431.92	21.59	–	453.51
20X2	453.51	22.68	–	476.19
20X3	476.19	23.81	(500)	–

(a) The effective interest rate of 5% per year is the rate that discounts the expected cash flows on the loan receivable to the initial carrying amount of CU431.92. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above). However, in this example, as there is only one payment, the effective interest rate can be determined by solving the equation $CU431.92 = CU500 \div (1 + X)^3$ where 'X' is the effective interest rate.

Therefore $(1 + X)^3 = CU500 \div CU431.92$, so $X = (CU500 \div CU431.92)^{1/3} \text{ less } 1 = 0.05$ (5%).

Ex 67 The facts are the same as in example 66. However, in this example, the 3-year loan was provided to the employee on 1 May 20X1. As a simplifying assumption, recognise interest on a proportionate basis and assume 365 days in each year.

Accrued interest on 31 December 20X1 is CU14.49 (that is, $CU21.59 \times 245 \div 365$ days)

Therefore, the journal entry in 20X1, excluding those on initial recognition are:

Dr	Loan receivable (financial asset)	CU14.49	
	Cr Profit or loss—interest income		CU14.49

To recognise interest income for the period.

Therefore, on 31 December 20X1 the loan has a carrying amount of CU446.41 (that is, $CU431.92 + CU14.49$).

Note: On 31 December 20X2 the loan has a carrying amount of CU468.73 (that is, $CU446.41 + (CU21.59 - CU14.49) + (CU22.68 \times 245 \div 365 \text{ days})$).

Module 11—Basic Financial Instruments

Ex 68 The facts are the same as in Example 45: On 1 December 20X1 an entity deposits CU20,000 into a 120-day notice deposit account with a bank. The entity will receive fixed interest at 1.644% for the 120-day period (equivalent to 5% per year, ignoring compounding), payable at the end of the deposit period. The market rate for this type of deposit with the bank is 1.644% per 120-day period.

On initial recognition, the deposit is measured at CU20,000 by the entity (see example 44).

In 120 days the CU20,000 will have increased by CU329 (that is, $CU20,000 \times 1.644\%$) to CU20,329.

<i>Time</i>	<i>Carrying amount at 1 December 20X1</i>	<i>Interest at 1.644%^(a)</i>	<i>Amount paid at 30 March 20X2</i>	<i>Carrying amount at 30 March 20X2</i>
120 days	20,000	329	(20,329)	—

(a) The effective interest rate of 1.644% is the rate that discounts the expected cash flows on the deposit to the initial carrying amount: $CU20,329 \div 1.01644 = CU20,000$
 The effective interest rate can be determined by solving the equation $CU20,000 = CU20,329 \div (1+X)$ where 'X' is the effective interest rate.
 Therefore $X = CU20,329 \div CU20,000$ less 1 = 0.01644.

On 31 December 20X1 the entity's financial year-end, 31 of the 120 days have passed. Because interest is payable in full at the end (that is, no compounding during the 120-day period), the interest of CU329 can be allocated on a straight-line basis during the 120 days.

At 31 December 20X1, the deposit will be recognised at CU20,085 (that is, $CU329 \times 31 \div 120$ days).

Module 11—Basic Financial Instruments

Ex 69 The facts are the same as in example 68. However, in this example, the entity paid the bank an upfront administration fee of CU50 to cover paperwork etc.

The deposit is recognised at CU20,050 by the entity on initial recognition (see example 45).

In 120 days the CU20,050 must increase to CU20,329 (repayment of CU20,000 principal and CU329 interest). The balancing figure is CU279 (that is, CU20,329 less CU20,050).

<i>Time</i>	<i>Carrying amount at 1 December 20X1</i>	<i>Interest at 1.392%^(a)</i>	<i>Amount paid at 30 March 20X2</i>	<i>Carrying amount at 30 March 20X2</i>
120 days	20,050	279	(20,329)	–

(a) The effective interest rate of 1.392% is the rate that discounts the expected cash flows on the deposit to the initial carrying amount of CU20,050.
 The effective interest rate can be determined by solving the equation $CU20,050 = CU20,329 \div (1 + X)$ where 'X' is the effective interest rate.
 Therefore $X = CU20,329 \div CU20,050$ less 1 = 0.0139.

On 31 December 20X1 the deposit will be measured at CU20,122 (that is, CU20,050 + (CU279 × 31 ÷ 120 days)).

Ex 70 On 1 January 20X2 a machine manufacturing entity sells a customer a machine for CU2,000 with payment in two years' time. The current cash sale price for that item if customers pay on delivery is CU1,650.

A trade receivable is recognised by the entity at CU1,650 on initial recognition. The difference between the current sale price and the consideration payable is recognised as interest revenue because it represents a financing transaction.

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 10.096%^(a)</i>	<i>Cash inflow</i>	<i>Carrying amount at 31 December</i>
20X1	1,650	166.59	–	1,816.59
20X2	1,816.59	183.41	(2,000)	–

(a) The effective interest rate of 10.096% is the rate that discounts the expected cash flows on the receivable to the initial carrying amount of CU1,650.
 The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above). However, in this example as there is only one payment the effective interest rate can be determined by solving the equation $CU1,650 = CU2,000 \div (1 + X)^2$ where 'X' is the effective interest rate.
 Therefore $(1 + X)^2 = CU2,000 \div CU1,650$, so $X = (CU2,000 \div CU1,650)^{1/2}$ less 1 = 0.10096.

The journal entry in 20X1, excluding those on initial recognition is:

Dr	Trade receivable (financial asset)	CU166.59	
	Cr Profit or loss—interest income		CU166.59

To recognise interest income for the period.

Module 11—Basic Financial Instruments

Ex 71 On 1 January 20X0 an entity acquires a zero-coupon bond in the market for CU98 plus transaction fees of CU2 in an arm's length transaction. The bond will be redeemed at CU126 on 31 December 20X4.

The bond is recognised at CU100 by the entity on initial recognition (see example 50).

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 4.73%^(a)</i>	<i>Cash inflow</i>	<i>Carrying amount at 31 December</i>
20X0	100.00	4.73	–	104.73
20X1	104.73	4.96	–	109.69
20X2	109.69	5.19	–	114.88
20X3	114.88	5.43	–	120.31
20X4	120.31	5.69	(126.00)	–

(a) The effective interest rate of 4.73% is the rate that discounts the expected cash flows on the loan receivable to the initial carrying amount of CU100. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above). However, in this example as there is only one payment the effective interest rate can be determined by solving the equation $CU100 = CU126 \div (1+X)^5$ where 'X' is the effective interest rate.

Therefore $(1 + X)^5 = CU126 \div CU100$, so $X = (CU126 \div CU100)^{0.2}$ less 1 = 0.0473.

The journal entry in 20X1, excluding those on initial recognition is:

Dr Bond (financial asset)	CU4.73	
Cr Profit or loss—interest income		CU4.73

To recognise interest income for the period.

Examples—financial liabilities

Ex 72 On 1 January 20X1 a bank provides an entity with a five-year loan of CU5,000 at a fixed interest rate of 8% per year for the first two years, after which the interest rate will be changed to reflect market interest rates at that time. The entity has a prepayment option where it can repay the loan in full after two years. The entity expects to repay the loan on this date. The prepayment option is not contingent on future events. Interest is payable at the end of each year. The figure of 8% is considered the market rate for similar two-year fixed-interest loans with interest paid yearly in arrears.

At inception the entity expects to repay the loan after two years, therefore the loan will be treated as if it is a two-year loan when determining the effective interest rate (that is, only two years of interest payments at 8% and repayment of principal at the end of the second year).

Since the interest is at market rate for a similar two-year loan, on initial recognition the entity measures the loan at the transaction price (that is, CU5,000).

Module 11—Basic Financial Instruments

As there are no transaction costs, the effective interest rate is 8% (see calculation below):

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 8% (a)</i>	<i>Cash outflow</i>	<i>Carrying amount at 31 December</i>
20X1	5,000	400	(400)	5,000
20X2	5,000	400	(5,400)	–

(a) The effective interest rate of 8% is the rate that discounts the expected cash flows on the loan to the initial carrying amount: $CU400 \div 1.08 + CU5,400 \div (1.08)^2 = CU5,000$. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above).

The journal entries in 20X1, excluding initial recognition, are:

Interest

Dr	Profit or loss—interest expense	CU400	
	Cr Loan (financial liability)		CU400

To recognise interest expense for the period.

Cash payment

Dr	Loan (financial liability)	CU400	
	Cr Cash (financial asset)		CU400

To recognise the settlement of financial liability.

The carrying amount of the loan at 31 December 20X1 is CU5,000.

Ex 73 **The facts are the same as in example 72. However, in this example, the entity obtains the loan after taking advice from a specialist loans broker. The broker charges the entity CU100 for these services.**

On initial recognition, the entity measures the loan at the transaction price less the broker's fees (that is, CU4,900).

The CU4,900 will accrete to CU5,000 over the two-year term using the effective interest method.

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 9.139%^(a)</i>	<i>Cash outflow</i>	<i>Carrying amount at 31 December</i>
20X1	4,900	447.82	(400)	4,947.82
20X2	4,947.82	452.18	(5,400)	–

(a) The effective interest rate of 9.139% is the rate that discounts the expected cash flows on the loan to the initial carrying amount: $CU400 \div 1.09139 + CU5,400 \div (1.09139)^2 = CU4,900$. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above).

Module 11—Basic Financial Instruments

Ex 74 The facts are the same as in example 72. However, in this example, the entity’s functional currency is FCU. Assume the following exchange rates are experienced over the loan:

- 1 January 20X1: FCU1 to CU5
- Average exchange rate in 20X1: FCU1 to CU5.5
- 31 December 20X1: FCU1 to CU5.1
- Average exchange rate in 20X2: FCU1 to CU4.5
- 31 December 20X2: FCU1 to CU4

The loan balances (which are monetary items) at year-end should be translated at the exchange rate at the year-end date. Interest should be translated at an average rate for the year.

The journal entries are:

Initial recognition

Dr	Cash (financial asset)	FCU1,000 ^(a)	
	Cr Loan (financial liability)		FCU1,000

To recognise the receipt of cash and the obligation to repay the loan.

20X1

Interest

Dr	Profit or loss—interest expense	FCU72.73 ^(b)	
	Cr Loan (financial liability)		FCU72.73

To recognise interest expense for the period.

Cash

Dr	Loan (financial liability)	FCU78.43 ^(c)	
	Cr Cash (financial asset)		FCU78.43

To recognise the settlement of a financial liability.

^(a) CU5,000 ÷ 5 = FCU1,000.
^(b) CU400 ÷ 5.5 = FCU72.73.
^(c) CU400 ÷ 5.1 = FCU78.43.

At 31 December 20X1 the loan is recorded at FCU980.39 (that is, CU5,000 ÷ 5.1)

Module 11—Basic Financial Instruments

An exchange gain of FCU13.91 arises from the difference between the FCU980.39 recorded at the 31 December 20X1 and the opening loan balance being adjusted for the interest and cash payments, that is, FCU994.30 (calculation: FCU1,000 + FCU72.73 less FCU78.43).

Therefore, further journal entries are:

20X1

Exchange gain

Dr	Loan (financial liability)	FCU13.91 ^(d)	
	Cr Profit or loss—exchange gain		FCU13.91

To recognise the foreign exchange gain on a financial liability.

20X2

Interest

Dr	Profit or loss—interest expense	FCU88.89 ^(e)	
	Cr Loan (financial liability)		FCU88.89

To recognise interest expense for the period.

Cash

Dr	Loan (financial liability)	FCU1,350 ^(f)	
	Cr Cash (financial asset)		FCU1,350

To recognise the settlement of a financial liability.

^(d) FCU994.30 less FCU980.39 = FCU13.91.

^(e) CU400 ÷ 4.5 = FCU88.89.

^(f) FCU5,400 ÷ 4 = FCU1,350.

At 31 December 20X2 the loan is fully repaid (last interest payment plus principal).

An exchange loss of FCU280.72 arises due to the difference between the FCU1,350 paid on 31 December 20X2 and the opening loan balance adjusted for the interest (that is, FCU1,069.28 (FCU980.39 + FCU88.89)).

Therefore, the further journal entries in 20X2 are:

Exchange loss

Dr	Profit or loss—exchange loss	FCU280.72 ^(g)	
	Cr Loan (financial liability)		FCU280.72

To recognise the foreign exchange loss on a financial liability.

^(g) FCU1,350 less FCU1,069.28 = FCU280.72

Module 11—Basic Financial Instruments

Ex 75 On 1 January 20X0 a bank provides an entity with a five-year loan for CU5,000. The bank charges the entity an interest rate of 10% with interest paid at the end of each year. The market rate for similar five-year fixed-interest loans with interest paid yearly in arrears is 8%. The bank transferred to the entity an additional amount (an upfront fee) of CU400 which is considered to compensate the entity for paying the higher rate of interest. The entity has a 31 December financial year-end.

The transaction amount, which is the face value of the loan plus the upfront cash payment is CU5,400 (see example 57).

The journal entries at the end of 20X0 are as follows (for calculations see the table below):

Interest

Dr	Profit or loss—interest expense	CU431.81	
	Cr Loan (financial liability)		CU431.81

To recognise interest expense for the period.

Cash payment

Dr	Loan (financial liability)	CU500	
	Cr Cash (financial asset)		CU500

To recognise the settlement of a financial liability.

On 31 December 20X0, the loan is recorded at CU5,331.81.

The effective interest rate is 8% rounded (that is, the market rate). See calculation below:

Time	Carrying amount at 1 January	Interest at 8% ^(a)	Cash outflow	Carrying amount at 31 December
20X0	5,400.00	431.81	(500.00)	5,331.81
20X1	5,331.81	426.36	(500.00)	5,258.17
20X2	5,258.17	420.47	(500.00)	5,178.64
20X3	5,178.64	414.11	(500.00)	5,092.76
20X4	5,092.76	407.24	(5,500.00)	(0.00)

(a) The effective interest rate of 8% (rounded) is the rate that discounts the expected cash flows on the loan to the initial carrying amount of CU5,400. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above).

Module 11—Basic Financial Instruments

Ex 76 On 1 January 20X0 Entity A issues a debt instrument for a price of CU1,250. The principal amount is CU1,250 and the debt instrument is repayable on 31 December 20X4. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6% in 20X0 (CU75), 8% in 20X1 (CU100), 10% in 20X2 (CU125), 12% in 20X3 (CU150), and 16.4% in 20X4 (CU205). The entity structured the payments in this manner to manage its cash flows. If it had borrowed at a fixed rate for the five years, the market rate of interest would have been 10%.

On initial recognition the loan is measured at CU1,250 (see example 58).

The journal entries at the end of 20X0 are as follows (for calculations see the table below):

Interest

Dr	Profit or loss—interest expense	CU125.16	
	Cr Loan (financial liability)		CU125.16

To recognise interest expense for the period.

Cash payment

Dr	Loan (financial liability)	CU75	
	Cr Cash (financial asset)		CU75

To recognise the settlement of a financial liability.

On 31 December 20X0, the loan is recorded at CU1,300.16.

The effective rate is 10.013% (see the table below).

The amortised cost in each period is as follows:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 10.013%^(a)</i>	<i>Cash outflow</i>	<i>Carrying amount at 31 December</i>
20X0	1,250.00	125.16	(75)	1,300.16
20X1	1,300.16	130.19	(100)	1,330.35
20X2	1,330.35	133.21	(125)	1,338.56
20X3	1,338.56	134.03	(150)	1,322.59
20X4	1,322.59	132.41	(1,455) = 205 + 1,250	—

(a) The effective interest rate of 10.013% per year is the rate that discounts the expected cash flows on the debt instrument to the initial carrying amount of CU1,250. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above).

Module 11—Basic Financial Instruments

Ex 77 On 1 April 20X1 a bank provides an entity with a four-year loan for CU5,000 under normal market terms for that type of loan, including charging interest at a variable rate of interest specified as LIBOR plus 2.5%, with interest payable annually in arrears. On 1 April 20X1 LIBOR is 2% and on 31 December 20X1 LIBOR is 2.5%.

Since interest is payable at the market rate for that type of loan, the loan is recorded by the entity at the transaction price of CU5,000, because the transaction price will approximate the present value of the future payments discounted at the market rate.

Since there are no transaction costs on the loan and the loan is recognised at transaction price, the effective interest rate on 1 April 20X1 is 4.5% (2% plus 2.5%).

The transaction price at which the loan is recognised is equal to the principal payable on maturity. Therefore, re-estimating the future interest payments will have no significant effect on the carrying amount of the loan (see paragraph 11.19). Cash flows over the life of the loan will constantly vary as LIBOR varies. However, because interest is charged at the market rate for this type of loan, if the effective interest rate is set to LIBOR plus 2.5% it will at any time always exactly discount estimated future cash payments over the remaining loan term to CU5,000. Hence, the carrying amount of the loan throughout the four years will be CU5,000.

Ex 78 The facts are the same as in example 77. However, in this example, the entity incurred transaction costs of CU50 on setting up the loan.

For simplicity, for variable rate loans it is better to consider transaction costs separately from the loan when determining the effective interest rate. This avoids having a different effective interest rate to the market rate (as the effective rate will need to take into account that the CU4,950 (net of CU50 transaction costs) needs to accrete to CU5,000). For fixed rate loans it is easier to include the transaction costs in the calculation as cash flows over the period of the loan are known.

The CU50 should be amortised over the four-year period using the effective interest method as follows:

	<i>Carrying amount at start of period</i>	<i>Transaction fees taken to profit or loss at 0.252%^(a)</i>	<i>Carrying amount at end of period</i>
Year 1	4,950.00	12.45	4,962.45
Year 2	4,962.45	12.48	4,974.93
Year 3	4,974.93	12.52	4,987.45
Year 4	4,987.45	12.55	5,000.00
		50.00	

(a) The effective interest rate of 0.252% per year is the rate that accretes CU4,950 to CU5,000 over the four-year period. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet (see note above).

Note: Any amount of the CU50 not yet amortised at any point in time will be netted off the loan in the statement of financial position. In effect, the calculation of the effective interest rate was computed in two separate parts.

Module 11—Basic Financial Instruments

Example—changes in estimated cash flows

Ex 79 On 1 January 20X1 a bank provides an entity with a four-year loan of CU5,000 under normal market terms, including interest at a fixed rate of 8%. Interest is payable at the end of each year. The figure of 8% is considered the market rate for similar four-year fixed-interest loans with interest paid at the end of each year (that is, annually in arrears). Transaction costs of CU100 are incurred on originating the loan.

On 31 December 20X1 the entity decides that it would like to repay half the loan on 31 December 20X2 and half on 31 December 20X3, instead of the full amount on 31 December 20X4. This will reduce the interest payments by CU200 in 20X3 and mean no interest is payable in 20X4. The contract allows for early prepayment at the option of the entity and so this is not a change in the terms of the loan.

Since the interest is at market rate, on 1 January 20X1 the entity will have initially recorded the loan at the transaction price, less transaction costs (CU4,900).

The following was the original amortised cost calculation at 1 January 20X1:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 8.612%^(a)</i>	<i>Cash outflow</i>	<i>Carrying amount at 31 December</i>
20X1	4,900.00	421.99	(400.00)	4,921.99
20X2	4,921.99	423.89	(400.00)	4,945.88
20X3	4,945.88	425.94	(400.00)	4,971.82
20X4	4,971.82	428.18	(5,400.00)	-

(a) The effective interest rate of 8.612% per year is the rate that discounts the original expected cash flows on the loan to the initial carrying amount of CU4,900. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet.

The original effective interest is 8.612% per year. Therefore, under the revised calculation at 31 December 20X1 the present value of revised estimated future cash flows discounted using the original effective interest rate (8.612%) is CU4,958.85 (for the calculation see the table below).

Under the original calculation on 31 December 20X1 the amortised cost was CU4,921.99. The difference of CU36.86 (CU4,958.85 less CU4,921.99) is recognised in profit or loss during 20X1.

Therefore, further journal entries to recognise this difference on 31 December 20X1 are as follows:

Dr	Profit or loss—expense	CU36.86	
	Cr Loan (financial liability)		CU36.86

To recognise the adjustment to the carrying amount of a financial liability due to changes in estimated cash flows.

Module 11—Basic Financial Instruments

Note: The interest expense and cash payment will be recognised in 20X1 as well as they are unaffected by the revised payments. The journal entries are as follows:

Interest incurred

Dr	Profit or loss—interest	CU421.99	
	Cr Financial (financial liability)		CU421.99

To recognise interest expense for the period.

Cash payment

Dr	Financial (financial liability)	CU400	
	Cr Cash		CU400

To recognise the settlement of a financial liability.

The discounted present value calculation at 31 December 20X1 is as follows:

Time	Cash outflow	Present value at 31 December 20X1 discounted at 8.612%
31 December 20X2	2,900 (ie 400 + 2,500)	$2,900 \div 1.08612 = 2,670.05$
31 December 20X3	2,700 (ie 200 + 2,500)	$2,700 \div 1.08612^2 = 2,288.80$
		Total present value = 4,958.85

The new amortised cost calculation at 1 January 20X2 is as follows:

Time	Carrying amount at 1 January	Interest at 8.612% (effective interest rate)	Cash outflow	Carrying amount at 31 December
20X2	4,958.85	427.06	(2,900.00)	2,485.91
20X3	2,485.91	214.09	(2,700.00)	–

Impairment of financial assets measured at cost or amortised cost

Recognition

- 11.21 At the end of each reporting period, an entity shall assess whether there is objective evidence of impairment of any 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.

Module 11—Basic Financial Instruments

Notes

Paragraphs 11.21–11.26 apply only to financial assets measured at cost or amortised cost. In other words, they do not apply to financial liabilities and they do not apply to financial assets measured at fair value with changes in fair value recognised in profit or loss. The fall (or rise) in fair value of a financial asset carried at fair value is recognised in profit or loss in the period of the change in fair value.

- 11.22 Objective evidence that a financial asset or group of assets is impaired includes observable data that come to the attention of the holder of the asset about the following loss events:
- (a) significant financial difficulty of the issuer or obligor;
 - (b) a breach of contract, such as a default or delinquency in interest or principal payments;
 - (c) the creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider;
 - (d) it has become **probable** that the debtor will enter bankruptcy or other financial reorganisation; or
 - (e) observable data indicating that there has been 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.

Notes

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) affects the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather, the combined effect of several events may have caused the impairment.

Losses expected as a result of future events (for example, an expectation of a downturn in the market), no matter how likely, are not recognised.

Examples of adverse national or local economic conditions referred to in paragraph 11.22(e) may include an increase in the unemployment rate in the geographical area of the creditors, a decrease in property prices for mortgages in the relevant area or a decrease in oil prices for loan assets to oil producers.

Module 11—Basic Financial Instruments

Example—impairment recognition

Ex 80 Entity A lends CU100 to an employee for one year with interest payable at 8%. The entity rarely makes loans to employees and therefore this is considered a one-off transaction. There is no reason to believe that the employee will not pay the interest and principal on the loan when it falls due. The market rate of interest for similar loans is 8% per year (that is, the market rate of interest for a similar loan to this individual). Similar to the approach in Example 81, Entity A wishes to recognise an impairment loss of CU10 on the loan because in the past, Entity A has found that, on average, 10% of its trade receivable balances (that is, amounts due from customers) are not repaid.

Entity A cannot recognise an impairment loss of CU10 based on its bad debt rate for its customers because there is no objective evidence of impairment of the loan to the employee as a result of a past event that occurred after initial recognition.

The employee loan does not have similar credit risk characteristics to the trade receivables and therefore cannot be grouped with trade receivables when considering impairment (see paragraph 11.24).

Only if there is objective evidence of impairment of the employee loan would an impairment loss be recognised. For example, if there was evidence that the employee was experiencing financial difficulties (for example, a declaration of such difficulties by the employee), meaning the employee might not be able to repay the loan on time, this would constitute objective evidence of a possible impairment.

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

Notes

Changes that have an adverse effect on the issuer may affect the issuer's ability to repay the holder and may be evidence of impairment of the related financial assets of the holder. Examples of the type of changes referred to in paragraph 11.23 include a reduction in the level of demand for the issuer's goods, legislation that affects the issuer's business, an increase in interest rates if the issuer has a high level of variable rate debt etc.

Other factors that an entity considers include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions and the fair value of collateral and guarantees.

Module 11—Basic Financial Instruments

11.24 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.

Notes

The only instruments in the scope of Section 11 that are included in paragraph 11.24(a) are investments in non-convertible preference shares and non-puttable ordinary or preference shares whose fair value cannot be measured reliably without undue cost or effort. Under the requirements of paragraph 11.24, all such instruments must be individually assessed for impairment.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics. Credit risk characteristics are indicative of debtors' ability to pay all amounts due according to the contractual terms and include characteristics such as asset type, industry, geographical location, collateral type, past-due status and other relevant factors. However, if information is available that specifically identifies losses on individual assets in a group even if not individually significant, those assets should be assessed individually (not as part of a group) unless those assets are collectively immaterial.

After initial recognition financial assets that are neither individually significant nor equity instruments can be tested for impairment in a group of similar assets (see paragraph 11.24). When there is an indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group, future cash flows in a group of financial assets are collectively evaluated for impairment. When historical loss experience is used it is adjusted on the basis of current observable data to reflect the effect of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

Section 11 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or attributed to identified groups of financial assets with similar credit risk characteristics on the basis of objective evidence about the existence of impairment in those assets. Reserves and other amounts that an entity might put aside for other reasons, such as regulatory requirements or tax purposes, but that cannot be supported by objective evidence about impairment, are not recognised as impairment losses.

Module 11—Basic Financial Instruments

Examples—unit of account for impairment testing

Ex 81 An entity sells goods on credit to its customers. At its year-end the entity has CU10,000 of trade receivable assets. In the previous year 2% of the trade receivable balances outstanding at year-end were never paid. Therefore, the entity wishes to recognise a general bad debt provision (an impairment loss) against trade receivables of 2% of CU10,000 (the carrying amount of trade receivables in the entity's statement of financial position would be CU9,800).

The entity knows that one customer with an outstanding balance of CU500 has gone into liquidation.

The method of loss provisions used by Entity A is not appropriate unless the customers have similar risk characteristics and the rates under the formula reflect actual experience of delinquencies, and those delinquency rates are projected to continue in the future. Moreover, if information is available that specifically identifies losses on any individual balances that do not follow the historical delinquency rates and those customer balances are not collectively immaterial, those specific balances must be assessed individually rather than applying the formula to them.

The CU500 balance is significant to the total trade receivable balance of CU10,000. Paragraph 11.24 requires financial assets that are individually significant to be assessed individually for impairment. This balance and any other significant trade receivable balances should be assessed individually for impairment.

Even if the CU500 balance were judged not individually significant it should be tested for impairment individually. Measurement of impairment on a group basis may be applied to groups of small balance items with similar credit risk characteristics only if there is indication of impairment in that group of similar assets but the impairment cannot be identified with an individual asset in that group.

In this example the entity should recognise a bad debt provision (that is, an impairment loss) against the CU500 owed by the customer who has gone into liquidation. A provision should be made based on how much of the CU500 the entity expects will not be recovered. The entity may be able to recognise further bad debt provisions for other trade receivable balances either individually or grouped on the basis of similar credit risk characteristics, provided there is objective evidence that the individual trade receivable balance or group of trade receivable balances are impaired.

Ex 82 An entity calculates impairment of a trade receivable on the basis of a formula that specifies fixed bad debt provision rates for the number of days a receivable has been classified as overdue (0% if fewer than 90 days, 20% if 90–180 days, 50% if 181–365 days and 100% if more than 365 days).

The method of loss provisions used by Entity A is not appropriate unless the customers have similar risk characteristics and the rates under the formula reflect actual experience of delinquencies, and those delinquency rates are projected to continue in the future. Moreover, if information is available that specifically identifies losses on any individual balances that do not follow the historical delinquency rates and those customer balances are not collectively immaterial, those specific balances must be assessed individually rather than applying the formula to them.

Module 11—Basic Financial Instruments

In the circumstances that the formula was appropriate, it must be reviewed for reasonableness on a regular basis. In particular, if the entity's customer base changes significantly, the formula may need to be revised to consider the risk characteristics of the new customer base. It is important that any method of determining impairment loss for trade receivables does not give a materially different value to the amount that would be determined by a strict application of paragraphs 11.24 and 11.25.

Ex 83 An entity has trade receivables in its statement of financial position. The entity determines, on the basis of historical experience, that one of the main causes of default on trade receivables is the death of the borrower. The entity observes that the death rate does not change significantly from one year to the next. Some of the borrowers in the entity's group of trade receivables may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity does not yet know which particular borrowers have died.

It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses (that is, a loss may be recognised on the basis of an expectation of deaths that have occurred during the period (before year-end)).

However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in future periods, because the necessary loss event (the death of the borrower) has not yet occurred.

Measurement

- 11.25 An entity shall measure an impairment loss on the following financial assets measured at cost or amortised cost as follows:
- (a) for a financial asset measured at amortised cost in accordance with paragraph 11.14(a), 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. If such a financial asset has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.
 - (b) for a financial asset measured at cost less impairment in accordance with paragraph 11.14(b) and (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.

Notes

The carrying amount of the asset is reduced, either directly or through use of an allowance account (for example, a 'bad debt provision' is sometimes used for trade receivables—see example 81). In the latter case the asset's carrying amount in the entity's statement of financial position is stated net of any related allowance. Whichever presentation is used, the amount of the impairment loss is recognised in profit or loss.

Module 11—Basic Financial Instruments

For an instrument accounted for in accordance with paragraph 11.25(a):

- The original effective interest rate is used as the discount rate for financial instruments with fixed rates of interest or fixed interest payments. Therefore, impairments arise solely from the reduction in expected cash flows and not changes in interest rates. If the terms of a financial instrument are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate.
- The current effective interest rate (see paragraph 11.19) should be used as the discount rate for financial instruments with variable rates of interest.
- Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial.
- The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable. Foreclosure is a proceeding in which the holder of a mortgage seeks to regain property because the borrower has defaulted on payments.
- Once a financial asset (or a group of similar financial assets) with a fixed interest rate has been impaired (in other words ‘written down’) as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

For an instrument accounted for in accordance with paragraph 11.25(b):

- Instruments measured at cost less impairment in accordance with paragraph 11.14(c)(ii) are those investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares whose fair value cannot be measured reliably without undue cost or effort. Since the fair value cannot be measured reliably without undue cost or effort, in most cases the best estimate of the amount that the entity would receive for the asset if it were to be sold at the reporting date will also be impossible to determine reliably. However, if there is objective evidence that an instrument has been impaired below its carrying amount (that is, cost less any previous impairment) it would be misleading to leave the value of the instrument unchanged in the statement of financial position and would result in an overstatement of an asset. Therefore, the entity must try to make an estimate of the impairment even if it is only a rough approximation. Such an approximation is better than simply ignoring the impairment.
- Paragraphs 11.27–11.32 provide guidance on how to measure fair value. This guidance should assist entities in applying paragraph 11.25(b) (that is, the hierarchy and valuation techniques may be used to create an estimate of the amount that the entity would receive for the asset if it were to be sold at the reporting date).

Module 11—Basic Financial Instruments

Examples—impairment loss measurement

Ex 84 At the end of a financial reporting period an entity has an outstanding balance of CU1,000 due from a customer. This balance was not discounted as the transaction took place on normal business terms (short-term credit) with no implicit financing transaction. Because of financial difficulties being experienced by the customer, the entity does not expect the customer to repay any of the CU1,000.

The entity must recognise an impairment loss for the full balance outstanding. The carrying amount of the trade receivable may either be reduced directly, as follows:

Dr	Profit or loss—impairment loss	CU1,000	
	Cr Trade receivables (financial asset)		CU1,000

To recognise the impairment loss.

or reduced through use of an ‘allowance account’ (for example, a ‘bad debt provision’), as follows:

Dr	Profit or loss—impairment loss	CU1,000	
	Cr Bad debt provision (set off against the financial asset)		CU1,000

To recognise the impairment loss.

In the latter case the carrying amount of the trade receivable is presented net of the bad debt provision in the entity’s statement of financial position.

Ex 85 The facts are the same as in example 84. However, in this example, the entity has given the customer extra time to pay off the debt. The entity expects the customer will be able to pay about one year after the reporting date. The market interest rate for a similar one-year loan to this customer is 5% per year.

The amount payable must now be discounted as the transaction is no longer on normal business terms and effectively includes a financing transaction (a one-year interest-free loan).

There is no original effective interest rate (as the instrument was not previously discounted) so the entity should use the market rate of interest for a similar one-year loan.

The receivable must be recognised at CU952.38 (that is, $CU1,000 \div 1.05$).

The carrying amount of the trade receivable may either be reduced directly, as follows:

Dr	Profit or loss—impairment loss	CU47.62	
	Cr Trade receivables (financial asset)		CU47.62

To recognise the impairment loss.

or reduced through use of an ‘allowance account’ (for example, a ‘bad debt provision’), as follows:

Dr	Profit or loss—impairment loss	CU47.62	
	Cr Bad debt provision (set off against the financial asset)		CU47.62

To recognise the impairment loss.

Module 11—Basic Financial Instruments

Ex 86 An entity is concerned that one of its customers (Customer B) will not be able to make all principal and interest payments due on a loan in a timely manner because the customer is experiencing financial difficulties. The entity and the customer negotiate a restructuring of the loan. The entity expects that the customer will be able to meet its obligations under the restructured terms. In which of the following cases (different restructuring scenarios) would the entity need to recognise an impairment loss?

- (a) Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.
- (b) Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.
- (c) Customer B will pay the full principal amount of the original loan on the original due date but with interest at a lower interest rate than the interest rate inherent in the original loan.
- (d) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.
- (e) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.

An impairment loss should be recognised in cases (a)–(d) as the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, given customer B's financial difficulties, case (e) would need to be carefully considered to ensure it is a realistic restructuring scenario.

Module 11—Basic Financial Instruments

Ex 87 On 1 January 20X1 an entity granted an interest-free loan of CU500 to an employee for a period of three years. The market rate of interest for similar loans is 5% per year (that is, the market rate of interest for a similar loan to this individual). The entity has a 31 December financial year-end.

On 31 December 20X2, because of financial difficulties, the employee asked to extend the interest-free loan for a further three years. The entity agreed. Under the restructured terms, repayment will take place on 31 December 20X6. However, the entity only expects to receive a payment of CU250, given the financial difficulty of the employee.

On initial recognition the loan receivable was recorded at CU431.92 (see example 48). The amortised cost calculation at 1 January 20X1 is as follows:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 5%</i>	<i>Cash inflow</i>	<i>Carrying amount at 31 December</i>
20X1	431.92	21.59	–	453.51
20X2	453.51	22.68	–	476.19
20X3	476.19	23.81	(500.00)	–

On 31 December 20X2 the carrying amount of the loan receivable is CU476.19.

As a result of that modification, on 31 December 20X2 the present value of estimated cash flows is recalculated to be CU205.68 using the asset’s original effective interest rate of 5% ($CU250 \div (1.05)^4$).

An impairment loss of CU270.51 (CU476.19 less CU205.68) is recognised in profit or loss in 20X2.

The carrying amount of the trade receivable may be reduced directly, as follows:

Dr	Profit or loss—impairment loss	CU270.51	
	Cr Loan receivable		CU270.51

To recognise the impairment loss.

In this case, the loan receivable will be measured at CU205.68 at 31 December 20X2.

Alternatively, it can be reduced through use of an ‘allowance account’ (for example, a ‘bad debt provision’), as follows:

Dr	Profit or loss—impairment loss	CU270.51	
	Cr Bad debt provision (set off against the financial asset)		CU270.51

To recognise the impairment loss.

Module 11—Basic Financial Instruments

The revised amortised cost calculation at 1 January 20X3 is as follows:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 5% (the original effective interest rate)</i>	<i>Cash inflow</i>	<i>Carrying amount at 31 December</i>
20X3	205.68	10.28	–	215.96
20X4	215.96	10.80	–	226.76
20X5	226.76	11.34	–	238.10
20X6	238.10	11.90	(250.00)	–

Ex 88 On 1 January 20X1 an entity granted a loan of CU5,000 to an employee for four years at an interest rate of 8% with interest paid annually in arrears. The market rate of interest for similar loans is 8% (that is, the market rate of interest for a similar loan to this individual). The entity has a 31 December year-end.

On 31 December 20X1 the employee told the entity that he was experiencing financial difficulties. The entity and the employee agreed to a restructuring of the payments under the loan. Under the revised terms, the employee is not required to pay any interest for 20X1 and 20X2 (that is, the interest is waived). However, interest payments in 20X3 and 20X4 are expected to be paid and the principal should be repaid as expected on 31 December 20X4.

On initial recognition, since the interest was at the market rate, the entity initially recorded the loan receivable at the transaction price (that is, CU5,000).

The amortised cost calculation at 1 January 20X1 is as follows:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 8%</i>	<i>Cash inflow</i>	<i>Carrying amount at 31 December</i>
20X1	5,000	400	(400)	5,000
20X2	5,000	400	(400)	5,000
20X3	5,000	400	(400)	5,000
20X4	5,000	400	(5,400)	–

On 31 December 20X1 the carrying amount of the loan receivable is CU5,400 (CU5,000 in the table above plus the CU400 of interest not paid in 20X1 as expected).

As a result of the restructuring, on 31 December 20X1 the present value of estimated cash flows discounted at the asset's original effective interest rate of 8% is CU4,629.63 (see the calculation at the end of this example).

Therefore, an impairment loss of CU770.37 (CU5,400 less CU4,629.63) is recognised in profit or loss for 20X2.

Module 11—Basic Financial Instruments

The entity has elected that the carrying amount of the trade receivable will be reduced directly, as follows:

Dr	Profit or loss—impairment loss	CU770.37	
	Cr Loan receivable		CU770.37

To recognise the impairment loss.

The loan receivable will be recognised at CU4,629.63 on 31 December 20X2.

The revised amortised cost calculation at 1 January 20X2 is as follows:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 8%</i>	<i>Cash inflow</i>	<i>Carrying amount at 31 December</i>
20X2	4,629.63	370.37	–	5,000.00
20X3	5,000.00	400.00	(400.00)	5,000.00
20X4	5,000.00	400.00	(5,400.00)	–

The discounted present value calculation at 31 December 20X1 is as follows:

<i>Time</i>	<i>Cash payment</i>	<i>Present value discounted at 8%</i>
31 December 20X3	400.00	$400 \div 1.08^2 = 342.94$
31 December 20X4	5,400.00	$5,400 \div 1.08^3 = 4,286.69$
		Total present value = 4,629.63

Reversal

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

Module 11—Basic Financial Instruments

Examples—reversal of a prior period impairment loss

Ex 89 The facts are the same as in example 84. However, in this example, after the prior-year financial statements were authorised for issue the entity received CU200 from the customer. The entity does not expect to receive the remaining CU800.

In the current reporting period, the entity must recognise a reversal of an impairment loss for the CU200 received.

If the carrying amount of the trade receivable was reduced directly under example 84, the entity would record the following journal entry to recognise the receipt of cash in the period of receipt:

Dr	Cash (financial asset)	CU200	
	Cr Profit or loss—reversal of impairment loss		CU200

To recognise the reversal of a prior period impairment loss.

If the carrying amount of the trade receivable was reduced through use of an ‘allowance account’ (for example, a ‘bad debt provision’) the entity should record the following journal entry to recognise the receipt of cash:

Dr	Cash (financial asset)	CU200	
	Cr Trade receivable (financial asset)		CU200

To recognise receipts from trade receivables.

Dr	Bad debt provision (set off against the financial asset)	CU200	
	Cr Profit or loss—reversal of impairment loss		CU200

To recognise the reversal of a prior period impairment loss.

Dr	Bad debt provision (set off against the financial asset)	CU800	
	Cr Trade receivable (financial asset)		CU200

To recognise the write-off of the remaining trade receivable.

Ex 90 The facts are the same as in example 87. However, in this example, on 14 December 20X4 the employee won the lottery and told the entity he will repay the loan in full in January 20X5 (two years ahead of the date agreed in the restructuring).

Without the decision to repay, on 31 December 20X4 the carrying amount of the loan receivable would have been CU453.51 (see the second table in example 87).

As the employee agreed before the year-end to repay the loan in full shortly after the year-end, the carrying amount of the loan is CU500. Discounting is not required because the payment will be received shortly after the year-end.

Therefore, a reversal of an impairment loss should be recognised in profit or loss for the year ended 31 December 20X4 of CU46.49 (that is, CU500 less CU453.51).

The journal entry is as follows:

Dr	Loan receivable (financial asset)	CU46.49	
	Cr Profit or loss—reversal of impairment loss		CU46.49

To recognise the reversal of a prior period impairment loss.

Module 11—Basic Financial Instruments

The loan receivable (financial asset) will be measured at CU500 at 31 December 20X4.

Fair value

11.27 An entity shall use the following hierarchy to estimate the fair value of an asset:

- (a) the best evidence of fair value is a quoted price for an identical asset (or similar asset) in an **active market**. This is usually the current bid price.
- (b) when quoted prices are unavailable, the price in a binding sale agreement or a recent transaction for an identical asset (or similar asset) in an arm's length transaction between knowledgeable, willing parties provides evidence of fair value. However, this price may not be a good estimate of fair value if there has been a significant change in economic circumstances or a significant period of time between the date of the binding sale agreement, or the transaction, and the measurement date. If the entity can demonstrate that the last transaction price is not a good estimate of fair value (for example, because it reflects the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), then that price is adjusted.
- (c) if the market for the asset is not active and any binding sale agreements or recent transactions of an identical asset (or similar asset) on their own are not a good estimate of fair value, an entity estimates the fair value by using another 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.

Other sections of this Standard make reference to the fair value guidance in paragraphs 11.27–11.32, including Section 9, Section 12, Section 14, Section 15, Section 16 *Investment Property*, Section 17 *Property, Plant and Equipment* and Section 28.

Notes

The only instruments in the scope of Section 11 that are measured at fair value are investments in non-convertible preference shares and non-puttable ordinary or preference shares if the shares are publicly traded or their fair value can otherwise be measured reliably without undue cost or effort. Therefore, the fair value guidance in this section focuses on these instruments only. Section 12 provides further fair value guidance for financial instruments in the scope of Section 12.

Identical assets (paragraph 11.27(a))

For an entity (entity X) holding an ordinary share or preference share of another entity (entity Y), an 'identical asset' to that share (referred to in paragraph 11.27(a)) would be a share in entity Y with identical terms and conditions. Ordinary shares in a company may be divided into different classes of shares, with each class having slightly different rights (for example, there may be 'A' ordinary and 'B' ordinary shares). An A ordinary share would not usually be an identical asset to a B ordinary share. Therefore, if there was a known fair value for the A ordinary shares (for example, due to a recent transaction in the A ordinary shares) this fair value could not be inferred as the fair value of the B ordinary shares. However, the price of A ordinary shares could be used as a starting point, with adjustments being made to account for the differences in terms and conditions between A ordinary shares and B ordinary shares.

Active market (paragraph 11.27(a))

Module 11—Basic Financial Instruments

The existence of published price quotations in an active market for identical assets, for example on a stock exchange, is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined as the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction (see Glossary). The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (that is, without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access.

If transactions are occurring frequently enough to generate reliable information on prices on a continuous basis, the market would be considered active. However, if transactions are no longer regularly occurring (even if prices are available) or the only transactions taking place are forced transactions, the market is no longer active. Judgement may need to be applied in assessing whether a market is active. An entity should evaluate the significance and relevance of all relevant factors, to determine whether, on the basis of the evidence available, a market is not active. If an entity concludes that a market is not active, transactions or quoted prices in that market may not be determinative of fair value.

Although an entity must have access to the market at the measurement date, it does not need to be able to sell the particular asset or transfer the particular liability on that date (for example, if there is a restriction on the sale of the asset). However, the entity must be able to access the market when the restriction ceases to exist. If a market participant would consider a restriction on the sale of an asset when determining the price for the asset, an entity shall adjust the quoted price to reflect the effect of that restriction.

In rare situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades or announcements) take place after the close of a market but before the measurement date. An entity establishes and consistently applies a policy for identifying those events that might affect fair value measurements.

Recent transactions (paragraph 11.27(b))

When quoted prices are unavailable, the price in a binding sale agreement or a recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances or a significant period of time between the date of the binding sale agreement, or the transaction, and the measurement date. If conditions have changed since the time of the transaction (for example, a major fire at an entity may seriously affect its share price), the fair value reflects the change in conditions. Similarly, if the entity can demonstrate that the last transaction price is not fair value (for example, because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted.

Unit of account

Module 11—Basic Financial Instruments

The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price.

Valuation technique

- 11.28 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 asset that is substantially the same as the asset being measured, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the asset and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.
- 11.29 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-determined inputs. A valuation technique would be expected to arrive at a reliable estimate of the fair value if
- (a) it reasonably reflects how the market could be expected to price the asset; and
 - (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk return factors inherent in the asset.

Notes

A valuation technique should incorporate all factors that market participants would consider in setting a price and should be consistent with accepted economic methodologies for pricing financial instruments. Choosing and applying valuation techniques often involves a significant amount of judgement. A technique should be selected that is appropriate for the instrument being valued and for which sufficient data are available, in particular data that maximise the use of market inputs (that is, inputs developed on the basis of available market data). Adjustments to market inputs may need to be made, depending on factors specific to the shares, for example the volume and level of sale and purchase activity of the shares. Once selected the valuation techniques should be applied on a consistent basis, unless a change in technique is appropriate because a different technique (for example, because a new valuation technique has been developed or additional information becomes available) would provide a more reliable estimate of fair value.

Entity-determined inputs are those that are not based on observable market data. However, they reflect the assumptions that market participants would use when pricing the shares, including assumptions about risk. In developing these inputs, an entity may begin with its own data, which is adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (for example, an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity cannot ignore information about market participant assumptions that is reasonably available.

If an entity makes significant use of valuation techniques, it should periodically test the techniques for validity using prices from any observable current market

Module 11—Basic Financial Instruments

transactions in the same instrument (that is, without modification or repackaging) or based on any available observable market data.

Examples—valuation techniques

Ex 91 Entity A owns 250 ordinary shares in company XYZ, an unquoted company. Company XYZ has a total share capital of 5,000 shares with nominal value of CU10. Entity XYZ's after-tax maintainable profits are estimated at CU70,000 per year. An appropriate price/earnings ratio determined from published industry data is 15 (before lack of marketability adjustment). Entity A's management estimates that the discount for the lack of marketability of company XYZ's shares and restrictions on their transfer is 20%. Entity A values its holding of company XYZ's shares on the basis of earnings.

An earnings-based valuation of Entity A's holding of shares in company XYZ could be performed as follows:

Value of company XYZ = CU70,000 × 15 × 0.8 = CU840,000.

Share price = CU840,000 ÷ 5,000 shares = CU168 per share.

The fair value of Entity A's investment in XYZ's shares is estimated at CU42,000 (that is, 250 shares × CU168 per share).

Ex 92 The facts are the same as in example 91. However, in this example, Entity A estimates the fair value of the shares it owns in company XYZ using a net asset valuation technique. The fair value of company XYZ's net assets including those recognised in its statement of financial position and those that are not recognised is CU850,000.

Share price = CU850,000 ÷ 5,000 shares = CU170 per share.

The fair value of Entity A's investment in XYZ shares is estimated to be CU42,500 (250 shares × CU170 per share).

Module 11—Basic Financial Instruments

No active market

- 11.30 The fair value of investments in assets 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 asset; or
 - (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- 11.31 There are many situations in which the variability in the range of reasonable fair value estimates of assets that do not have a quoted market price is likely not to be significant. Normally it is possible to estimate the fair value of an 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 asset at fair value.
- 11.32 If a reliable measure of fair value is no longer available for an asset measured at fair value (or is not available without undue cost or effort when such an exemption is provided (see paragraphs 11.14(c) and 12.8(b)), its carrying amount at the last date the asset was reliably measurable becomes its new cost. The entity shall measure the asset at this cost amount less impairment until a reliable measure of fair value becomes available (or becomes available without undue cost or effort when such an exemption is provided).

Derecognition of a financial asset

- 11.33 An entity shall derecognise a financial asset only when either:
- (a) the contractual rights to the cash flows from the financial asset expire or are settled;
 - (b) the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or
 - (c) the entity, despite having retained some significant risks and rewards of ownership, 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 retained or created in the transfer.

The carrying amount of the transferred asset shall be allocated between the rights or obligations retained and those transferred on the basis of 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.

Module 11—Basic Financial Instruments

Notes

Contractual rights to cash flows (paragraph 11.33(a))

The rights to the cash flows expire when, for example, a financial asset reaches its maturity and there are clearly no further cash flows arising from that asset. The rights to the cash flows are settled (see paragraph 11.33(a)) when, for example, a customer pays the full trade receivable balance or a party to which the entity has made a loan repays all the outstanding interest and the principal amount.

Transfer of risks and rewards (paragraph 11.33(b))

Paragraph 11.33(b) requires an entity, in considering whether to derecognise a financial asset, to determine whether the entity has transferred to another party substantially all of the risks and rewards of ownership. However, the *IFRS for SMEs* Standard does not provide guidance on how to make this judgement. In these circumstances the entity may (but is not required to) look to full IFRS Standards for guidance. IAS 39 paragraph 21 provides guidance as follows:

‘The transfer of risks and rewards (...) is evaluated by comparing the entity’s exposure, before and after the transfer, to the variability in the amounts and timing of the net cash flows of the transferred asset’

Judgement needs to be applied when applying the risks and rewards test.

If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset. If an entity retains only some of the risks and rewards of ownership, paragraph 11.33(c) applies.

An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (for example, because the entity has sold a financial asset subject to an agreement to buy it back at a price fixed at the sale price plus a lender’s return, or because the entity has guaranteed a level of return to the transferee).

An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (for example, because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase).

Transfer of control (see paragraph 11.33(c))

Whether the entity has retained control (see paragraph 11.33(c)) of the transferred asset depends on the transferee’s ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability freely the entity has not retained control. In all other cases, the entity has retained control. In order for the transferee to be able to exercise the ability freely the transferee must be able to exercise that ability unilaterally (that is, the transferee’s ability to dispose of the transferred asset must be independent of the actions of others) and without needing to impose additional restrictions on the transfer (for example, conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

Module 11—Basic Financial Instruments

A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the transferor to repurchase it, but the transferee can immediately obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot immediately obtain the transferred asset in the market if the entity exercises its option.

The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

- a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and
- an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
 - the transferee's ability to dispose of the transferred asset must be independent of the actions of others (that is, it must be a unilateral ability); and
 - the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (for example, conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset.

Upon derecognising a financial asset in its entirety, the difference between the carrying amount and the consideration received (including any new asset obtained less any new liability assumed) is recognised in profit or loss.

Module 11—Basic Financial Instruments

Examples—derecognition of financial assets

Ex 93 The following are four examples of when an entity must derecognise a financial asset because it has transferred substantially all the risks and rewards of ownership of a financial asset:

- An unconditional sale of a financial asset.
- A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase (from a risks and rewards perspective this is the same as an unconditional sale of the asset and a subsequent reacquisition of the asset in the market at a later date).
- A sale of a financial asset while retaining only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it.
- A sale of 100 shares for CU30 per share together with an option for the purchaser to require the entity (the seller) to repurchase the shares at CU30 each if the quoted market price falls below CU10 within the next month. As market conditions are good, it is highly unlikely that the share price will fall below CU10 (that is, it is highly unlikely that the entity will need to repurchase the shares). Therefore, this is effectively an unconditional sale.

Ex 94 The following are five examples of when an entity has retained substantially all the risks and rewards of ownership of a financial asset and therefore should not derecognise the asset:

- A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return.
- A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return and the transferee has a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.
- A sale of a financial asset under an agreement to repurchase substantially the same asset at a fixed price or at the sale price plus a lender's return.
- A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.
- A sale of 100 shares for CU30 per share together with a contractual provision that the entity has to repurchase the shares at CU31 if the quoted market price does not rise to CU60 or above within the next month. As market conditions are 'flat', it is highly unlikely that the share price will double within the next month (that is, it is highly likely that the seller will be required to repurchase the shares). The seller retains the price risk and pays a lender's return. The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale.

Ex 95 An entity sells its investment in unquoted shares to a bank for CU1,000. One year later the entity repurchases those shares from the bank for CU1,200.

The repurchase of the investment in itself does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if the agreement to sell the investment in shares is entered into concurrently with the agreement to repurchase the shares at a fixed price or the sale price plus a lender's return, then the asset is not derecognised. In the latter case, the CU200 in this example would represent the lender's return.

Module 11—Basic Financial Instruments

- 11.34 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.
- 11.35 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** (for example, 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; and
 - (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.

Notes

A transferor may be required to provide non-cash collateral to the transferee in a transfer agreement between the transferor and transferee. Collateral is an asset that is promised or given to the transferee (such as a bank or a factor entity) to guarantee the discharge of an obligation by the transferor.

The transferee's (for example, bank's) entitlement to the collateral is conditional upon the default of the transferor (the entity borrowing from the bank). Provided the transferor does not default under the contract, the transferor continues to benefit from the collateral's risks and rewards. The transferee is not entitled to recognise the collateral, and the transferor does not derecognise the collateral unless the transferor defaults under the terms of the contract.

Module 11—Basic Financial Instruments

Example—transfer that qualifies for derecognition

An entity sells a group of its accounts receivable to a bank at less than their face amount. The entity continues to handle collections from the debtors on behalf of the bank, including sending monthly statements, and the bank pays the entity a market-rate fee for servicing the receivables. The entity is obliged to remit promptly to the bank any and all amounts collected, but it has no obligation to the bank for slow payment or non-payment by the debtors. In this case, the entity has transferred to the bank substantially all of the risks and rewards of ownership of the receivables. Accordingly, it removes the receivables from its statement of financial position (ie derecognises them), and it shows no liability in respect of the proceeds received from the bank. The entity recognises a loss calculated as the difference between the carrying amount of the receivables at the time of sale and the proceeds received from the bank. The entity recognises a liability to the extent that it has collected funds from the debtors but has not yet remitted them to the bank.

Example—transfer that does not qualify for derecognition

The facts are the same as the preceding example except that the entity has agreed to buy back from the bank any receivables for which the debtor is in arrears as to principal or interest for more than 120 days. In this case, the entity has retained the risk of slow payment or non-payment by the debtors—a significant risk with respect to receivables. Accordingly, the entity does not treat the receivables as having been sold to the bank, and it does not derecognise them. Instead, it treats the proceeds from the bank as a loan secured by the receivables. The entity continues to recognise the receivables as an asset until they are collected or written off as uncollectable.

Examples—factorised trade receivables (see paragraphs 11.33 and 11.34)

Ex 96 An entity enters into an arrangement with a third party under which the entity sells trade receivable assets with a carrying amount of CU19,000 (CU20,000 gross amount less CU1,000 ‘bad debt allowance’) to the third party. The third party pays the entity CU18,000 for the receivables. The entity and the third party estimate, on the basis of the entity’s experience, that CU19,000 of the CU20,000 trade receivables will be settled (bad debt losses are expected to be CU1,000). However, the entity has not guaranteed to the third party that any particular amount will be collected. The trade debtors will pay the entity and the entity will pass all receipts to the third party.

Ultimately, because of one customer going into liquidation, only CU17,000 of the trade receivables were actually settled. Therefore, the entity passed only CU17,000 to the third party.

In this case, the entity has transferred to the third party substantially all of the risks and rewards of ownership of the receivables. In particular the third party has the major risk, which is the credit risk. The third party would have benefited from any upside (that is, if all CU20,000 of the debtors had paid, the third party would have received CU20,000).

Accordingly, the entity removes the receivables of CU19,000 from its statement of financial position (that is, derecognises them), and it shows no liability in respect of the proceeds received from the third party.

Module 11—Basic Financial Instruments

The entity should recognise a loss on sale of CU1,000 calculated as the difference between the carrying amount of the receivables at the time of sale (CU19,000) and the proceeds received from the third party of CU18,000.

The journal entries on transfer are as follows:

Dr	Cash (financial asset)	CU18,000	
Dr	profit or loss—loss on sale of trade receivables	CU1,000	
	Cr Trade receivables (financial asset)		CU19,000

To derecognise factorised trade receivables.

The entity recognises a financial liability for any cash receipts from the debtors that it has not yet passed on to the third party.

The journal entries would be as follows on collection of cash:

Dr	Cash (financial asset)	CUX	
	Cr Amount collected on behalf of third party (financial liability)		CUX

To recognise cash collected on behalf of third party.

The entity may pass the cash to the third party immediately, or it may wait and remit all amounts collected at certain periods of time or in full on a certain date. If, for example, the entity waited until all CU17,000 of receipts were received it would have a financial liability for CU17,000. In this case, on payment to the third party, the following journal entries should be recognised:

Dr	Amount collected on behalf of third party (financial liability)	CU17,000	
	Cr Cash (financial asset)		CU17,000

To recognise the transfer of cash collected on behalf of third party to the third party.

Ex 97 The facts are the same as in example 96. However, in this example, the entity will pass all receipts to the third party up to a maximum of CU19,000. Also, if receipts are less than CU19,000 the entity will make up the difference (that is, in all cases the third party will receive CU19,000).

As only CU17,000 of the trade receivables are settled by the entity’s customers, the entity pays a further CU2,000 on to the third party.

In this example, the entity has not transferred to the third party substantially all of the risks and rewards of ownership of the receivables—the entity retains the major risk which is the credit risk (the risk of debtors not paying). The entity also benefits from any upside (that is, if all CU20,000 of the debtors had paid, the entity would still pay only CU19,000 to the third party).

Accordingly, the entity does not treat the receivables as having been sold to the third party (that is, it does not derecognise them). The entity continues to recognise the trade receivables as an asset until they are collected or written off as uncollectible.

The substance of the transaction with the third party is a secured loan—the loan is secured by the trade receivables. The entity receives a loan of CU18,000 and repays

Module 11—Basic Financial Instruments

CU19,000, the difference of CU1,000 is a finance cost (interest) of the entity, that is, it is the lender's return (interest).

The journal entries are:

Initial recognition

Dr	Cash (financial asset)	CU18,000	
	Cr Loan (financial liability)		CU18,000

To recognise the loan.

During loan period

Dr	Profit or loss—interest expense	CU1,000	
	Cr Loan (financial liability)		CU1,000

To recognise interest expense for the period.

Ex 98 The facts are the same as in example 96. However, in this example, the entity will pass all receipts to the third party up to a maximum of CU19,500. If receipts are less than CU17,200 the entity will make up the difference. Under the contract, the third party is prohibited from selling the receivables to another party.

As only CU17,000 of the trade receivables are actually settled, the entity pays a further CU200 on to the third party.

In this case, the entity has retained some of the risks and rewards of ownership of the receivables. The entity and the third party both share the credit risk (the risk of debtors not paying). Also, the entity and the third party can both benefit from the upside.

As the third party is prohibited from selling the receivables, the entity still has control of the trade receivables. Therefore, the entity does not treat the receivables as having been sold to the third party, and it does not derecognise them. The entity continues to recognise the receivables as an asset until they are collected or written off as uncollectible.

The entity shall recognise a financial liability for the consideration received of CU18,000.

Module 11—Basic Financial Instruments

Ex 99 The facts are the same as in example 96. However, in this example, the entity will pass all receipts to the third party up to a maximum of CU19,500. If receipts are less than CU17,200 the entity will make up the difference. Under the contract the third party has the practical ability to sell the financial receivables in their entirety to another party and can exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. As only CU17,000 of the trade receivables are actually settled, the entity pays a further CU200 on to the third party.

In this case, the entity has retained some of the risks and rewards of ownership of the receivables. The entity and the third party both share credit risk (the risk of debtors not paying). Both can also benefit from the upside.

As the third party can sell the receivables freely, the third party would be considered to have control. Therefore, the entity should derecognise the trade receivables and recognise separately the financial instrument created which results from the requirement either to pay further contingent amounts to the supplier (if receipts are less than CU17,200) or to receive an additional amount of up to CU500 (if receipts are greater than CU19,500). This financial instrument does not satisfy the conditions in paragraph 11.9 and therefore it is outside the scope of Section 11. This financial instrument is accounted for in accordance with Section 12 and will not be addressed further here. However, it is addressed in Module 12.

Derecognition of a financial asset

11.36 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, is cancelled or expires.

Notes

A financial liability is extinguished when the entity (the debtor) discharges the liability by paying the creditor with cash or other financial assets or if the entity is released from settling the liability by the creditor.

A financial liability will also be extinguished if the entity is released from settling the liability by process of law. Some jurisdictions have a 'statute of limitations' which is a statute that sets out the maximum period of time, after certain events have taken place, that legal proceedings based on those events may be initiated. For example, if such a period was five years, a supplier would no longer be able to legally enforce payment by a customer if the supplier did not claim payment within five years from the date the goods were provided. Until five years have passed, the customer would be legally required to pay the supplier should the supplier make a claim and so it would not be appropriate for the customer to derecognise any related financial liability.

Payment to a third party, including a trust, where the payment is to be used solely for satisfying scheduled payments of both interest and principal of the outstanding debt (sometimes called in-substance defeasance), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

Module 11—Basic Financial Instruments

If an entity pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the entity does not derecognise the debt obligation unless it is legally released from primary responsibility for the liability.

In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:

- recognises a new financial liability for its obligation for the guarantee (note, the guarantee is within the scope of Section 12); and
- recognises a gain or loss based on the difference between (a) any proceeds paid and (b) the carrying amount of the original financial liability less the fair value of the new financial liability.

11.37 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.

11.38 The entity shall recognise in profit or loss any difference between the carrying amount of the 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.

Notes

In considering whether the exchange of financial instruments must be accounted for as an extinguishment, an entity must judge whether the terms (for example, maturity date, interest rate, face value, collateral, loan covenants, currency, etc) of the instruments exchanged are substantially different (see paragraph 11.37). However, the *IFRS for SMEs* Standard does not provide guidance on how to make this judgement. In these circumstances the entity may (but is not required to) look to full IFRS Standards for guidance (see paragraph 10.6). Paragraph AG62 of IAS 39 provides guidance as follows—the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability.

If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment.

If the exchange or modification is not accounted for as an extinguishment, it is accounted for as a change in estimated cash flows (see paragraph 11.20). Any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

Module 11—Basic Financial Instruments

Examples—derecognition of financial liabilities

Ex 100 On 1 January 20X1 a bank provides an entity with a four-year loan of CU5,000 on normal market terms, including charging interest at a fixed rate of 8% per year. Interest is payable at the end of each year. The figure of 8% is the market rate for similar four-year fixed-interest loans with interest paid annually in arrears. Transaction costs of CU100 are incurred on originating the loan.

In 20X1 the entity experienced financial difficulties. On 31 December 20X1 the bank agreed to modify the terms of the loan. Under the new terms the interest payments in 20X2 to 20X4 will be reduced from 8% to 5%. The entity paid the bank a fee of CU50 for paperwork relating to the modification.

Since the interest was initially set at the market rate, on 1 January 20X1 the entity must on initial recognition measure the loan at the transaction price, less transaction costs (that is, CU4,900).

The following was the original amortised cost calculation at 1 January 20X1.

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 8.612%^(a)</i>	<i>Cash outflow</i>	<i>Carrying amount at 31 December</i>
20X1	4,900.00	421.99	(400.00)	4,921.99
20X2	4,921.99	423.89	(400.00)	4,945.88
20X3	4,945.88	425.94	(400.00)	4,971.82
20X4	4,971.82	428.18	(5,400.00)	—

^(a) The effective interest rate of 8.612% per year is the rate that discounts the original expected cash flows on the loan to the initial carrying amount of CU4,900.

At 31 December 20X1:

- the present value of the remaining cash flows of the original financial liability is CU4,921.99 discounted at the original effective interest rate of 8.612%.
- the present value of the cash flows under the new terms discounted using the original effective interest rate is CU4,539.67 (see table below). Including the CU50 fee, the present value of the total cash flows is CU4,589.67.
- the difference between CU4,921.99 and CU4,589.67 is CU332.32 which is only 6.8% (CU332.32 ÷ CU4,921.99) of the present value of the remaining cash flows of the original financial liability.

The entity applies its judgement to decide whether the terms of the instruments exchanged are substantially different. If entity decides to look to full IFRS Standards for guidance, then it would consider whether the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. As this difference is less than 10% of the present value of the remaining cash flows of the original financial liability, the entity concluded that this modification should not be considered a substantial modification of the terms of the existing loan. Therefore,

Module 11—Basic Financial Instruments

the modification would not be accounted for as an extinguishment of the original financial liability.

The calculation of the present value of the cash flows under the new terms discounted using the original effective interest rate is as follows:

<i>Time</i>	<i>Cash outflow</i>	<i>Present value at 31 December 20X1 discounted at 8.612%</i>
31 December 20X2	250.00	$250 \div 1.08612 = 230.18$
31 December 20X3	250.00	$250 \div 1.08612^2 = 211.93$
31 December 20X4	5,250.00	$5,250 \div 1.08612^3 = 4,097.56$
		Total present value = 4,539.67

Ex 101 The facts are the same as in example 100. However, in this example, the entity is not required to pay any interest under the revised terms of the loan. The entity needs to repay only the principal and this will be paid a year later than under the original terms (that is, on 31 December 20X5).

At 31 December 20X1:

- the present value of the remaining cash flows of the original financial liability is CU4,921.99 discounted at the original effective interest rate of 8.612%.
- the present value of the cash flows under the new terms discounted using the original effective interest rate is CU3,593.01 ($CU5,000 \div (1.08612)^4$). Including the CU50 fee, the present value of the total cash flows is CU3,643.01.
- the difference between CU4,921.99 and CU3,643.01 is CU1,278.98 which is 26% ($CU1,278.98 \div CU4,921.99$) of the present value of the remaining cash flows of the original financial liability.

The entity applies its judgement to decide whether the terms of the instruments exchanged are substantially different. If the entity decides to look to full IFRS Standards for guidance, then it would consider whether the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. The difference is more than 10% of the present value of the remaining cash flows of the original financial liability.

The entity concludes that the modification is a substantial modification of the terms of the existing loan. Therefore, this debt restructuring would be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The journal entries on extinguishment of the existing loan are as follows:

Dr	Loan (financial liability)	CU4,921.99	
	Cr Profit on derecognition of loan (CU4,921.99 less CU3,675.15 less CU50)		CU1,196.84
	Cr New loan (financial liability) (see below)		CU3,675.15
	Cr Cash (financial asset)		CU50.00

To recognise the extinguishment of the loan.

Module 11—Basic Financial Instruments

The new financial liability is an interest-free loan of CU5,000 for four years. Assume 8% is considered to be the market rate for similar four-year fixed-interest loans with interest paid annually in arrears. The entity measures the new loan at the present value of the future payments discounted at a market rate of interest for a similar loan (CU5,000 ÷ (1.08)⁴).

The amortised cost calculation at 1 January 20X2 is as follows:

<i>Time</i>	<i>Carrying amount at 1 January</i>	<i>Interest at 8%</i>	<i>Cash outflow</i>	<i>Carrying amount at 31 December</i>
20X2	3,675.15	294.01	–	3,969.16
20X3	3,969.16	317.53	–	4,286.69
20X4	4,286.69	342.94	–	4,629.63
20X5	4,629.63	370.37	(5,000.00)	–

Disclosures

11.39 The following disclosures make reference to disclosures for financial liabilities measured at fair value through profit or loss. Entities that have only basic financial instruments (and therefore do not apply Section 12) will not have any financial liabilities measured at fair value through profit or loss and hence will not need to provide such disclosures.

Disclosure of accounting policies for financial instruments

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

Example—disclosure of accounting policies for financial instruments

Ex 102 Extract from notes to Entity A’s financial statements for the year ended 31 December 20X2

Note 2 Accounting policies
<p><i>Investments in non-puttable ordinary shares</i></p> <p>Investments in non-puttable ordinary shares in entities that are not associates, joint ventures or subsidiaries are initially measured at the transaction price, excluding any transaction costs. Thereafter, such investments are measured at fair value with changes in fair value recognised in profit or loss. If fair value cannot be measured reliably without undue cost or effort, investments are measured at cost less impairment. Dividends are included in other income.</p> <p><i>Loan receivables</i></p> <p>Entity A occasionally provides its associates or employees with loans. Loan receivables are measured at amortised cost using the effective interest method less any impairment. Interest income is included in other income.</p>

Module 11—Basic Financial Instruments

Trade receivables

Most sales are made on normal short-term credit terms. Trade receivables in respect of such sales are measured at the undiscounted amount of cash expected to be received less any impairment. For sales made on terms that extend beyond normal credit terms, receivables are initially measured at the present value of future receipts discounted at a market rate of interest and are subsequently measured at amortised cost using the effective interest method.

Impairment of financial assets

At the end of each reporting period, the carrying amounts of financial assets that are not measured at fair value are reviewed to determine whether there is any objective evidence of impairment. If so, an impairment loss is recognised immediately in profit or loss and the carrying amount of trade receivables is reduced accordingly.

Trade payables

Trade payables are obligations that have arisen by purchasing goods and services under normal short-term credit terms. Trade payables are measured at the undiscounted amount of cash to be paid. Entity A buys some goods from overseas suppliers. Trade payables denominated in a foreign currency are translated into CU using the exchange rate at the reporting date. Foreign exchange gains or losses are included in other income or other expenses.

Bank loans and overdrafts

Loans are measured at amortised cost using the effective interest method. Interest expense is recognised on the basis of the effective interest method and is included in finance costs.

Overdrafts are repayable in full on demand and are initially measured and subsequently stated at face value (the amount of the loan).

Statement of financial position—categories of financial assets and financial liabilities

- 11.41 An entity shall disclose the carrying amounts of each of the following categories of financial assets and financial liabilities at the reporting date, in total, either in the statement of financial position or in the notes:
- (a) financial assets measured at fair value through profit or loss (paragraph 11.14(c)(i) and paragraphs 12.8 and 12.9);
 - (b) financial assets that are debt instruments measured at amortised cost (paragraph 11.14(a));
 - (c) financial assets that are equity instruments measured at cost less impairment (paragraph 11.14(c)(ii) and paragraphs 12.8 and 12.9);
 - (d) financial liabilities measured at fair value through profit or loss (paragraphs 12.8 and 12.9);
 - (e) financial liabilities measured at amortised cost (paragraph 11.14(a)); and
 - (f) loan commitments measured at cost less impairment (paragraph 11.14(b)).

Module 11—Basic Financial Instruments

Notes

An entity may wish to present the disclosures required by paragraph 11.41 in a separate table (see example 103), particularly if the entity has many different types of financial instruments. However, if an entity has relatively few financial instruments and the information required in paragraph 11.41 is already shown directly in the financial statements, there is no need for the entity to present a separate disclosure item for this information.

Example—separate disclosure of categories of financial assets and financial liabilities

Ex 103 Extract from notes to Entity A's financial statements for the year ended 31 December 20X2

Note 14 Carrying amounts of financial assets and financial liabilities

	<i>Fair value</i>		<i>Amortised cost</i>		<i>Total</i>	
	<i>through profit</i>					
	<i>or loss</i>					
	<i>20X2</i>	<i>20X1</i>	<i>20X2</i>	<i>20X1</i>	<i>20X2</i>	<i>20X1</i>
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<u>Financial assets</u>						
Investments in equity instruments	10,140	11,810	–	–	10,140	11,810
Loan receivables	–	–	4,000	2,000	4,000	2,000
Trade receivables	–	–	585,548	487,678	585,548	487,678
Total	10,140	11,810	589,548	489,678	599,688	501,488
<u>Financial liabilities</u>						
Trade and other payables	–	–	412,127	389,666	412,127	389,666
Overdraft	–	–	33,600	15,508	33,600	15,508
Bank loans	–	–	390,000	150,000	390,000	150,000
Total	–	–	835,727	555,174	835,727	555,174

Module 11—Basic Financial Instruments

11.42 An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its **financial position** and **performance**. For example, for long-term debt such information would normally include the terms and conditions of the debt instrument (such as interest rate, maturity, repayment schedule, and restrictions that the debt instrument imposes on the entity).

Example—disclosure to evaluate the significance of financial instruments for the financial position and performance of an entity

Ex 104 Extract from notes to Entity A’s financial statements for the year ended 31 December 20X2

Note 25 Bank overdrafts and loans

	20X2	20X1
	CU	CU
Bank overdraft	33,600	15,508
Fixed rate bank loan	105,000	150,000
Variable rate bank loan	285,000	–
Total	423,600	165,508

The bank overdraft is repayable on demand. Interest is payable on the bank overdraft at LIBOR plus 2%.

Interest is payable on the seven-year bank loan at a fixed rate of 5% of the principal amount. The bank loan is fully repayable in 20X6. Early payment is permitted without penalty.

The bank overdraft and fixed-rate bank loan are secured by a floating lien over the entity’s land and buildings with a carrying amount of CU266,000 at 31 December 20X2 (CU312,000 at 31 December 20X1) (see note 12).

Interest is payable on the variable-rate loan at LIBOR plus 1%. The variable-rate bank loan is fully repayable on 16 January 20X3. Early payment is prohibited. The variable-rate loan is secured by CU300,000 of trade receivables (see note 16).

Module 11—Basic Financial Instruments

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

Notes

If an entity uses a valuation technique to measure any investments in shares, it is very important to disclose which valuation method has been used and the significant assumptions applied. Such disclosures will be specific to the entity and the type of shares being valued. It is important that the disclosures inform users of the entity’s financial statements of the extent of judgement involved in performing the valuation. Disclosures should assist users to assess the level of subjectivity involved and to assess whether the assumptions used are appropriate.

The disclosure in example 105 is for reference only. Entities should explain their own specific facts and circumstances and add additional information, where relevant to users, to enhance the quality of the disclosures.

Example—disclosure of the basis for determining fair value of financial assets and financial liabilities

Ex 105 Extract from notes to Entity A’s financial statements for the year ended 31 December 20X2

Note 14 Investments in equity securities

	20X2	20X1
	CU	CU
Listed non-puttable ordinary shares	8,440	10,200
Unlisted non-puttable ordinary shares	1,700	1,610
Total	10,140	11,810

The fair value of the entity’s investments in listed equity securities is based on quoted market prices at the reporting date on the [National Stock Market]. The quoted market price used is the current bid price.

The fair value of the entity’s investments in unlisted equity securities is determined using a discounted cash flow analysis based on assumptions that are supported by observable market data, where available. For the discounted cash flow analysis, an earnings growth factor of 4%, equal to the industry average, is used. A risk-free interest rate of 6% is used to discount the cash flows as the estimated cash flows themselves are adjusted for risk.

Module 11—Basic Financial Instruments

11.44 If a reliable measure of fair value is no longer available, or is not available without undue cost or effort when such an exemption is provided, for any financial instruments that would otherwise be required to be measured at fair value through profit or loss in accordance with this Standard, the entity shall disclose that fact, the carrying amount of those financial instruments and, if an undue cost or effort exemption has been used, the reasons why a reliable fair value measurement would involve undue cost or effort.

Derecognition

11.45 If an entity has transferred financial assets to another party in a transaction that does not qualify for derecognition (see paragraphs 11.33–11.35), the entity shall disclose the following for each class of such financial assets:

- (a) the nature of the assets;
- (b) the nature of the risks and rewards of ownership to which the entity remains exposed; and
- (c) the carrying amounts of the assets and of any associated liabilities that the entity continues to recognise.

Example—disclosure of derecognition of financial assets

Ex 106 Extract from notes to Entity A’s financial statements for the year ended 31 December 20X2

Note 16 Trade and other receivables

	20X2	20X1
	CU	CU
Trade receivables	585,548	487,678
Prepayments	1,700	1,610
Total	587,248	489,288

During 20X2 the entity sold CU300,000 of its trade receivables to a bank for CU280,000. The entity continues to handle collections from the debtors on behalf of the bank. The entity will buy back any receivables for which the debtor is in arrears as to principal or interest for more than 120 days. The entity continues to recognise the full carrying amount of the receivables sold (CU300,000) and has recognised the cash received on the transfer as a secured loan for CU280,000. At 31 December 20X2 the carrying amount of the loan is CU285,000 including accrued interest of CU5,000 under the effective interest method (see note 25). The bank is not entitled to sell the trade receivables or use them as security for its own borrowings.

Module 11—Basic Financial Instruments

Collateral

- 11.46 When an entity has pledged financial assets as collateral for liabilities or **contingent liabilities**, it shall disclose the following:
- (a) the carrying amount of the financial assets pledged as collateral; and
 - (b) the terms and conditions relating to its pledge.

Example—disclosure of financial assets pledged as collateral

Ex 107 Extract from notes to Entity A's financial statements for the year ended 31 December 20X2

Note 25 Bank overdrafts and loans

The bank overdraft and fixed-rate loan are secured by a floating lien over land and buildings owned by the group with a carrying amount of CU266,000 at 31 December 20X2 (CU312,000 at 31 December 20X1). The secured loan is secured over CU300,000 of trade receivables (see note 16).

Defaults and breaches on loans payable

- 11.47 For **loans payable** recognised at the reporting date for which there is a breach of terms or default of principal, interest, sinking fund or redemption terms that have not been remedied by the reporting date, an entity shall disclose the following:
- (a) details of that breach or default;
 - (b) the carrying amount of the related loans payable at the reporting date; and
 - (c) whether the breach or default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

Example—disclosure of defaults and breaches on loans payable

Ex 108 Extract from notes to Entity A's financial statements for the year ended 31 December 20X2

Note 25 Bank overdrafts and loans

At 31 December 20X2 Entity A was late in making an interest payment on the fixed-interest loan of CU100,000 and therefore the outstanding interest of CU5,000 is accrued at year-end. The interest was paid in January 20X3. Although the entity is subject to a penalty charge for any late payment, the bank has stated in writing that, on this occasion, it will not impose the penalty.

Module 11—Basic Financial Instruments

Items of income, expense, gains or losses

- 11.48 An entity shall disclose the following items of income, expense, **gains** or losses:
- (a) income, expense, gains or losses, including changes in fair value, recognised on:
 - (i) financial assets measured at fair value through profit or loss;
 - (ii) financial liabilities measured at fair value through profit or loss;
 - (iii) financial assets measured at amortised cost; and
 - (iv) financial liabilities measured at amortised cost.
 - (b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not measured at fair value through profit or loss; and
 - (c) the amount of any impairment loss for each class of financial asset.

Example—disclosure of items of income, expense, gains or losses

Ex 109 Extracts from notes to Entity A's financial statements for the year ended 31 December 20X2:

Note 8 Other income (extract)

	20X2	20X1
	CU	CU
Dividends	460	430
Interest income	300	290

Note 9 Finance costs (extract)

	20X2	20X1
	CU	CU
Interest on bank overdraft and loans	13,450	9,110

Note 10 Profit for the year (extract)

	20X2	20X1
	CU	CU
Gains (losses) on changes in fair value recognised on subsequent measurement or disposal of investments in equity securities	569	(123)
Bad debt expense on trade receivables	(32,300)	(24,240)
Exchange gains (losses) on trade payables	(149)	123

Module 11—Basic Financial Instruments

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* Standard to transactions or other events often requires the exercise of judgement. Information about significant judgements made by an entity's management and key sources of estimation uncertainty are useful when assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements management has made when applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, in accordance with paragraph 8.7, an entity must disclose information that explains key assumptions about the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* Standard require disclosure of information about particular judgements and estimation uncertainties.

Initial measurement

Assessing whether a transaction contains a hidden financing transaction may require judgement, particularly if normal credit terms in the industry or of the entity are not well defined and the entity does not enter into similar transactions not on credit. If the amount receivable or payable is higher than the cash value of an item or if payment is deferred for more than a few months, this suggests that the transaction may involve a financing element.

Judgement may be required in determining the market rate of interest for a similar debt to use as the discount rate if a transaction takes place otherwise than on an arm's length basis, for example between two related parties. In particular, this will be the case if published information for similar debts is not available, for example if the debt has unusual features, such as a very long term, or the credit rating of the entities is unknown. Usually financing transactions between two unrelated parties will be made on an arm's length basis and therefore are financed at a market rate of interest.

Determining which costs to treat as transaction costs on initial recognition of a financial instrument may also require judgement to be exercised. Transaction costs are only those incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. In practice, judgement may need to be applied to distinguish such costs from other costs arising on initial recognition, such as debt premiums or discounts, financing costs or internal administrative costs.

Module 11—Basic Financial Instruments

Subsequent measurement

Deciding whether the fair value of a particular investment can be measured reliably without undue cost or effort using a valuation model also usually involves judgement.

Judgement is required in estimating the fair value of investments in ordinary shares and preference shares when there is no active market. In particular, choosing and applying valuation techniques involves a significant amount of judgement. Often the inputs into the valuation model and other assumptions used when applying the model are subjective.

Judgement may also be required in assessing whether or not a market is active if transactions are not occurring frequently and whether the transactions taking place are forced transactions.

Estimating cash flows when determining the amortised cost of a financial instrument may require judgement. For example, some instruments allow early prepayment by the issuer (debtor). In this case the holder and the issuer need to estimate when the loan will be repaid when determining the future cash flows to be used in the amortised cost calculation.

Judgement is usually required when assessing whether financial assets measured at cost or amortised cost are impaired and hence when an impairment test must be performed. In particular, Section 11 requires financial assets that are individually significant to be assessed for impairment separately. Deciding which assets are ‘individually significant’ requires judgement.

Performing an impairment test for investments in preference shares and ordinary shares whose fair value cannot be measured reliably without undue cost or effort requires significant judgement. Since the fair value cannot be measured reliably without undue cost or effort, in most cases the best estimate of the amount the entity would receive for the asset if it were to be sold at the reporting date will need to be estimated. Therefore, the entity must use judgement to estimate the impairment even though this might be only a rough approximation in some cases.

Derecognition

Judgement is sometimes required in assessing whether substantially all the risks and rewards are transferred to another party when determining whether to derecognise a financial asset.

Module 11—Basic Financial Instruments

COMPARISON WITH FULL IFRS STANDARDS

When the *IFRS for SMEs* Standard was issued in July 2009, Section 11 was based on IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. At that time IFRS 9 *Financial Instruments* had not been issued. Since then, IFRS 9 has been issued in its final form and is effective for annual periods beginning on or after 1 January 2018. The *IFRS for SMEs* Standard issued in 2015 continues to allow preparers to apply the recognition and measurement requirements of IAS 39 instead of those of Sections 11 and 12 (paragraph 11.2(b)), and so the comparison will continue to be made for IAS 39. In addition, for reference, a comparison with IFRS 9 is provided.

Comparison with IAS 39

IAS 39 and the *IFRS for SMEs* Standard (see Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*) share some similar principles for the recognition, measurement and disclosure of financial instruments. However, there are a number of significant differences.

In the *IFRS for SMEs* Standard the accounting for basic financial instruments is addressed separately from the accounting for more complex financial instrument transactions and the requirements have been written in simplified language. In addition, there are a number of changes in the details (outlined below).

Under the *IFRS for SMEs* Standard an entity shall choose to account for all of its financial instruments either:

- (a) by applying the provisions of both Section 11 and Section 12 in full; or
- (b) by applying the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of Section 11 and Section 12.

If an entity chooses to apply (b)

The difference between applying (b) and applying full IFRS Standards is the applicable disclosure requirements. IFRS 7's disclosures are divided into three main categories: significance, risk and transfers. Section 11 includes many of the 'significance' disclosures in IFRS 7. However, the *IFRS for SMEs* Standard includes none of the 'risk' disclosures in IFRS 7. The only disclosure from IFRS 7 relating to 'transfers' that is included in the *IFRS for SMEs* Standard relates to transfers of financial assets that do not qualify for derecognition.

The reasons that the *IFRS for SMEs* Standard omits so many of the IFRS 7 disclosures include:

- (a) many of the IFRS 7 disclosures are designed for financial institutions (which are not eligible to use the *IFRS for SMEs* Standard);
- (b) many of the IFRS 7 disclosures are designed for entities whose securities trade in public capital markets (which are also ineligible to use the *IFRS for SMEs* Standard); or
- (c) in the case of disclosure of fair values for all financial instruments measured at amortised cost, requiring such disclosures would be burdensome for small or medium-sized entities and contrary to the objective of Section 11, which is an amortised cost section for basic financial instruments.

Module 11—Basic Financial Instruments

If an entity chooses to apply (a)

There are many differences between Section 11 and full IFRS Standards, including the disclosure differences mentioned for (b) above. Other main differences include:

- (a) *Classification of financial instruments*: Under Section 11, financial instruments that meet specified criteria are measured at cost or amortised cost, with an exemption for a few instruments which are measured at fair value through profit or loss. The fair value option, and the available-for-sale and held-to-maturity classifications in IAS 39 are not available. This therefore removes the requirement to assess management's intentions regarding financial instruments and avoids the need for accounting 'penalties' in Section 11 (for example, tainting provisions for held-to-maturity assets).
- (b) *Initial recognition*: Section 11 requires instruments to be measured at transaction price unless the arrangement constitutes a financing transaction, in which case the cash flows from the instrument are discounted. Under IAS 39, financial instruments are initially measured at fair value. In practice, the different terminology is unlikely to result in any significant difference in value on initial recognition.
- (c) *Derecognition*: Section 11 establishes a simple principle for derecognition. That principle does not rely on the 'pass-through' and 'continuing involvement' provisions that apply to derecognition under IAS 39. The derecognition provisions of the *IFRS for SMEs* Standard would not result in derecognition for some factoring transactions that a small or medium-sized entity may enter into, whereas IAS 39 would result in derecognition.

Comparison with IFRS 9

In July 2014 the Board issued the final version of IFRS 9, the new Standard on financial instruments. The most significant changes compared to IAS 39 are a new model for classification and measurement of financial assets and a new impairment model. IFRS 9 has an effective date for annual periods that begin on or after 1 January 2018.

The recognition and derecognition requirements are largely unchanged between IAS 39 and IFRS 9, so the section on 'initial recognition' and 'derecognition' also applies for IFRS 9.

Unlike Section 11, IFRS 9 has three categories for classification: fair value through profit or loss (FVTPL), fair value through other comprehensive income (FVTOCI) and amortised cost (AC). IFRS 9 does not permit any instruments to be measured at cost.

The classification of financial instruments under IFRS 9 is based on the contractual cash flows of the instrument as well as the business model in which it is held. Those criteria are different to the criteria used for classification of financial instruments in Section 11.

Generally, applying IFRS 9, the classification is mandatory based on the aforementioned criteria. However, there are some exceptions. An entity can, for example, elect to designate a financial instrument at FVTPL if certain criteria are met. This option is not available in the *IFRS for SMEs* Standard.

The impairment model is based on expected losses and is therefore significantly different from the impairment model in Section 11, which is based on incurred losses. Applying IFRS 9, if credit risk has increased significantly since initial recognition, the entity has to provide for the lifetime expected losses of the instrument. For all other instruments, an entity has to provide for the losses expected within 12 months of the year end on a probability-weighted basis.

The requirements in IFRS 9 for financial liabilities are similar to those of Section 11. There are also several differences between Section 12 and full IFRS Standards. These differences are not covered in this module.

Module 11—Basic Financial Instruments

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting basic financial instruments in accordance with the *IFRS for SMEs* Standard by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume all amounts are material.

Mark the box next to the most correct statement.

Question 1

Under the *IFRS for SMEs* Standard an entity can choose to apply the provisions of both Section 11 and Section 12 in full, or alternatively the entity may apply:

- (a) full IFRS Standards for financial instruments (that is, the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement*, and the presentation and disclosure requirements of IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosures*).
- (b) the recognition and measurement provisions of Section 11 and Section 12 and the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*.
- (c) the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of Section 11 and Section 12.
- (d) the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*.

Question 2

Which of the following items in an entity's statement of financial position is a financial asset or financial liability within the scope of Section 11?

- (a) a liability for an amount due to a supplier for a past receipt of goods.
- (b) an asset for a prepayment made to a supplier for the rent of a machine for two months.
- (c) a liability for a fine for the late payment of income tax by the entity.
- (d) all of the above.

Question 3

Which of the following financial assets is not within the scope of Section 11?

- (a) cash.
- (b) trade receivables.
- (c) a 5% holding in the non-puttable ordinary shares of another entity (investee).
- (d) a 30% holding in the non-puttable ordinary shares of another entity (investee) where the investee is classified as an associate of the entity.

Module 11—Basic Financial Instruments

Question 4

Which of the following financial instruments is not within the scope of Section 11?

- (a) investments in non-convertible, non-puttable preference shares.
- (b) financial instruments that meet the definition of an entity's own equity.
- (c) a fixed-interest fixed-term loan from a bank.
- (d) an interest-free three-year loan from a parent entity.

Question 5

An entity buys 100 non-puttable ordinary shares in a listed company on the market for cash of CU20 per share. The entity also incurred broker's fees of CU100.

At what amount should the entity measure the investment in shares on initial recognition?

- (a) CU1,900.
- (b) CU2,000.
- (c) CU2,100.

Question 6

A bank provides an entity with a five-year loan for CU10,000 with fixed interest payable annually in arrears at a rate of 6% of the principal amount. 6% is considered to be the market rate for a similar five-year loan with interest payable annually in arrears. The bank charges the entity a fee of CU50 for paperwork.

At what amount should the entity measure the loan on initial recognition?

- (a) CU9,384.
- (b) CU9,484.
- (c) CU9,950.
- (d) CU10,000.
- (e) CU10,050.

Question 7

At the end of each reporting period investments in non-convertible preference shares and non-puttable ordinary or preference shares should be measured as follows:

- (a) all such investments shall be measured at fair value with changes in fair value recognised in profit or loss.
- (b) all such investments shall be measured at amortised cost using the effective interest method.
- (c) all such investments shall be measured at cost less impairment.
- (d) if the shares are publicly traded, the investment should be measured at fair value with changes in fair value recognised in profit or loss. All other such investments must be measured at cost less impairment.
- (e) if the shares are publicly traded or their fair value can otherwise be measured reliably without undue cost or effort, the investment should be measured at fair value with changes in fair value recognised in profit or loss. All other such investments must be measured at cost less impairment.

Module 11—Basic Financial Instruments

Question 8

On 1 January 20X1 an entity provides an employee with a four-year interest-free loan of CU1,000. The market rate of interest for a loan to this individual is 8% per year. At what amount is the loan measured on initial recognition and how much interest income is recognised for the year ended 31 December 20X1?

- (a) on 1 January 20X1 the loan is measured at CU735.03. Interest income for the year ended 31 December 20X1 is CU0 in 20X1.
- (b) on 1 January 20X1 the loan is measured at CU735.03. Interest income for the year ended 31 December 20X1 is CU58.80 in 20X1.
- (c) on 1 January 20X1 the loan is measured at CU1,000. Interest income for the year ended 31 December 20X1 is CU0 in 20X1.
- (d) on 1 January 20X1 the loan is measured at CU1,000. Interest income for the year ended 31 December 20X1 is CU80 in 20X1.

Question 9

When assessing financial assets held at amortised cost or cost for impairment an entity must assess which of the following assets individually?

- (a) only financial assets that are individually significant.
- (b) only equity instruments that are individually significant.
- (c) only equity instruments.
- (d) all financial assets except equity instruments.
- (e) all equity instruments and other financial assets that are individually significant.

Question 10

An entity sells a group of its accounts receivable to a bank at less than their 'face amount'. The entity continues to handle collections from the debtors on behalf of the bank, and the bank pays the entity a market-rate fee for servicing the receivables. The entity is obliged to remit promptly to the bank any and all amounts collected, but it has no obligation to the bank for slow payment or non-payment by the debtors.

What is the correct accounting treatment for this transaction?

- (a) The entity should remove the receivables from its statement of financial position (that is, derecognise them), and show no liability in respect of the proceeds received from the bank.
- (b) The entity should continue to recognise the receivables in its statement of financial position and show a liability in respect of the proceeds received from the bank.
- (c) The entity should continue to recognise the receivables in its statement of financial position and show no liability in respect of the proceeds received from the bank.
- (d) The entity should remove the receivables from its statement of financial position (that is, derecognise them), and show a liability in respect of the proceeds received from the bank.

Module 11—Basic Financial Instruments

Answers

- Q1 (c) see paragraph 11.2
- Q2 (a) see paragraph 11.3 (definitions of financial assets and financial liabilities)
- Q3 (d) see paragraph 11.7(a)
- Q4 (b) see paragraph 11.7(b)
- Q5 (b) see paragraph 11.13
- Q6 (c) see paragraph 11.13
- Q7 (e) see paragraph 11.14
- Q8 (b) see paragraph 11.16
- Q9 (e) see paragraph 11.24
- Q10 (a) see paragraph 11.33–11.35

Module 11—Basic Financial Instruments

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting basic financial instruments in accordance with the *IFRS for SMEs* Standard by solving the case studies below.

Once you have completed the case studies check your answers against those set out at the bottom of this test.

Case study 1

An entity has the following trial balance for the year ended 31 December 20X1.

Balance	20X2 CU	In scope of Section 11?	Subsequent measurement under Section 11		
			Fair value	Amortised cost	Cost less impairment
Opening retained earnings	(1,961,353)				
Share capital (40,000 ordinary shares with par value CU1.00)	(40,000)				
Property, plant and equipment	2,349,945				
Intangible assets	850				
Investments in associates	107,500				
Deferred tax asset	4,309				
Inventory	57,381				
Trade receivables	565,548				
Cash on hand	13,980	Yes	Always measured at cash equivalent in functional currency.		
Investment in non-puttable ordinary shares in a listed company	4,740				
Investment in non-puttable non-convertible preference shares in an unlisted company	3,210				
Investment in fixed-interest fixed-term bonds	5,180				
Investment in mutual fund that is not classified as equity (portfolio of equity and debt securities)	4,100				
Deposit at bank (Fixed term. Fixed interest)	10,000				
Loan receivable from employee (Fixed term. Fixed interest)	1,000				
Loan receivable from associate (Interest-free. Repayable on demand. Denominated in foreign currency)	4,000				
Bank loans (Fixed term. Fixed interest)	(110,000)				

Module 11—Basic Financial Instruments

Other long-term employee benefits	(10,623)				
Obligations under finance leases	(44,624)				
Trade payables	(392,127)				
Warranty (obligation is to repair or replace any returned goods)	(23,552)				
Rent payable	(1,000)				
Interest payable	(2,000)				
Current tax liability	(271,648)				
Bank overdrafts (due on demand. Interest payable at variable market rate)	(40,110)				

Revenue	(6,888,545)
Cost of sales	5,178,530
Other income	(63,850)
Distribution costs	175,550
Admin expenses	810,230
Other costs	106,763
Finance costs	26,366
Income tax	270,250
Dividends	150,000
	<u>(0)</u>

Using the columns on the right, note which items are within the scope of Section 11 and, for those that are, whether they should be measured after initial recognition at FVTPL, amortised cost or cost less impairment.

Ignore the part of the trial balance that relates to the statement of comprehensive income. As cash is a special case which does not fit into the three measurement categories, the answer has been given.

Module 11—Basic Financial Instruments

Answer to case study 1

<i>Balance</i>	<i>20X2 CU</i>	<i>In scope of Section 11?</i>	<i>Subsequent measurement under Section 11</i>		
			<i>Fair value</i>	<i>Amortised cost</i>	<i>Cost less impairment</i>
Opening retained earnings	(1,961,353)	No. Entity's own equity. See Section 22 (paragraph 11.7(b))			
Share capital (40,000 ordinary shares with par value CU1.00)	(40,000)	No. Entity's own equity. See Section 22 (paragraph 11.7(b))			
Property, plant and equipment	2,349,945	No. Not a financial asset.			
Intangible assets	850	No. Not a financial asset.			
Investments in associates	107,500	No. See Section 14 (paragraph 11.7(a))			
Deferred tax asset	4,309	No. Not a financial asset. Statutory not contractual.			
Inventory	57,381	No. Not a financial asset.			
Trade receivables	565,548	Yes		√ Measured at the undiscounted amount of cash expected to be received (ie net of impairment) unless the arrangement constitutes, in effect, a financing transaction (see paragraph 11.14(a)).	
Cash on hand	13,980	Yes	Always measured at cash equivalent in functional currency.		
Investment in non-puttable ordinary shares in a listed company	4,740	Yes	√ Shares are publicly traded (paragraph 11.14(c)(i))		
Investment in non-puttable non-convertible	3,210	Yes	√ If fair value can be measured		√ If fair value cannot be

Module 11—Basic Financial Instruments

preference shares in an unlisted company			reliably without undue cost or effort (paragraph 11.14(c)(ii))		measured reliably without undue cost or effort (paragraph 11.14(c)(ii))
Investment in fixed-interest fixed-term bonds	5,180	Yes, assuming bond satisfies paragraph 11.9(b)-(d)		√	
Investment in mutual fund that is not classified as equity (portfolio of equity and debt securities)	4,100	No. Does not satisfy paragraph 11.9. In Section 12.			
Deposit at bank (Fixed term. Fixed interest)	10,000	Yes, assuming it satisfies paragraph 11.9(b)-(d)		√	
Loan receivable from employee (Fixed term. Fixed interest)	1,000	Yes, assuming it satisfies paragraph 11.9(b)-(d)		√	
Loan receivable from associate (Interest-free. Repayable on demand. Denominated in foreign currency)	4,000	Yes, assuming it satisfies paragraph 11.9(b)-(d)			
Bank loans (Fixed term. Fixed interest)	(110,000)	Yes, assuming loan satisfies paragraph 11.9(b)-(d)		√	
Other long-term employee benefits	(10,623)	No. See Section 28 (paragraph 11.7(d))			
Obligations under finance leases	(44,624)	No. See Section 20 (paragraph 11.7(c))			
Trade payables	(392,127)	Yes		√ Measured at the undiscounted amount of cash expected to be paid unless the arrangement constitutes, in effect, a financing transaction (see paragraph 11.14(a)).	

Module 11—Basic Financial Instruments

Warranty (Obligation is to repair or replace any returned goods)	(23,552)	No. Not a financial liability. Will not result in delivery of cash/financial assets.			
Rent payable	(1,000)	Yes		√ Measured at the undiscounted amount of cash expected to be paid unless the arrangement constitutes, in effect, a financing transaction (see paragraph 11.14 (a)).	
Interest payable	(2,000)	Yes		√ Measured at the undiscounted amount of cash expected to be paid unless creditor allows the interest payment to be deferred and this deferral constitutes, in effect, a financing transaction (see paragraph 11.14 (a)).	
Current tax liability	(271,648)	No. Not a financial liability. Statutory not contractual.			
Bank overdrafts (Due on demand. Interest payable at variable market rate)	(40,110)	Yes, assuming it satisfies paragraph 11.9(b)-(d)		√ As the overdraft is payable on demand the amount due is not discounted.	

Module 11—Basic Financial Instruments

Case study 2

On 1 January 20X1 Entity A made the following loans to other parties:

- Loan to an employee: A five-year loan to an employee for CU500. However, the loan permits early payment and the employee and Entity A expect that the employee will repay the loan in full on 31 December 20X2. Interest is charged at the fixed rate of 4% of the principal amount per year. Interest is payable to the entity annually in arrears. The market rate for similar five-year loans to this individual is 7%.
- Loan to an associate: A four-year loan to an associate for CU5,000. Interest is charged at the fixed rate of 5% of the principal amount per year. Interest is payable to the entity annually in arrears. The market rate for similar four-year loans to the associate is 5%.

On 1 January 20X1 a bank provided Entity A with the following loans:

- Three-year fixed-rate bank loan: A three-year loan for CU10,000. Interest is charged at the fixed rate of 6%. Interest is payable annually in arrears. The market rate for similar three-year loans is 6% per year. The bank charged the entity CU100 for administration costs.
- Overdraft: An overdraft facility for up to CU2,000 for 6 years. Interest is charged at EURIBOR plus 250 points. Interest is added to the overdraft annually in arrears but payment is deferred until settlement of the overdraft. The market rate for similar overdrafts is EURIBOR plus 250 points. The overdraft is repayable on demand. On 1 January 20X1 CU500 was withdrawn to purchase raw materials, creating an overdraft of that amount.
- The bank overdraft and fixed-rate bank loan are secured by a floating lien over land and buildings owned by the entity with a carrying amount of CU56,000 at 31 December 20X2 (CU42,000 at 31 December 20X1).

At 1 January 20X1 Entity A already has a five-year loan with another bank for CU5,000. Interest is charged at EURIBOR plus 200 points. The market rate for similar loans is EURIBOR plus 200 points. Interest is payable annually in arrears and the entity pays this immediately when it is due in cash. The loan was entered into on 1 January 20X0.

In 20X1 the associate unexpectedly experienced financial difficulties due to a health scare regarding one of the associate's leading products. Entity A and the associate agreed to a restructuring of the terms of the loan on 31 December 20X1. Interest accrued for 20X1 was not paid. No interest will be charged during 20X2 and 20X3 and the term of the loan should be extended to 20X7. Hence the full principal is payable on 31 December 20X7. Interest at 5% per year will be payable during 20X4–20X7.

In 20X1 the entity withdrew a further CU400 from the overdraft facility to buy raw materials, and incurred interest of CU44 on the overdraft, bringing the outstanding balance to CU944 at year-end.

In 20X2 the entity withdraws a further CU300 from the overdraft facility to buy raw materials. In 20X2 interest of CU55 is incurred on the overdraft.

During 20X1 EURIBOR is a weighted average of 3% and during 20X2 it is a weighted average of 2.5%.

Module 11—Basic Financial Instruments

Part A

Prepare the journal entries to record the two loans receivable and two loans payable on 1 January 20X1 (that is, initial recognition).

Part B

Prepare the journal entries to account for the all of the loans receivable and payable mentioned above during 20X1 and 20X2 and determine their carrying amounts at year-end 31 December 20X1 and year-end 31 December 20X2.

Part C

Prepare notes to satisfy the disclosure requirements in Section 11 for all the loans receivable and payable as they may be presented in the financial statements for the year ended 31 December 20X2 (with comparatives for 20X1 where required).

Module 11—Basic Financial Instruments

Answer to Case Study 2—Part A

(1) Loan to employee (financial asset)

The loan is recorded at its present value of CU472.88^(a) discounted using the market rate of interest of 7%. The expected cash flows (over a two-year period) are used rather than the contractual cash flows (over the full five-year term).

The difference between the amount of cash provided to the employee (CU500) and the amount the loan is measured at on initial recognition (that is, CU472.88) is CU27.12. The CU27.12 difference is accounted for as employee remuneration in accordance with Section 28 *Employee Benefits*. It will either be recognised immediately in profit or loss or deferred depending on whether there are further services conditions involved for the employee to satisfy regarding the loan.

The journal entries on 1 January 20X1 (initial recognition) are as follows:

Dr	Loan receivable (financial asset)	CU472.88	
Dr	Employee benefits expense (profit or loss) or employee benefits paid in advance (asset)	CU27.12	
	Cr Cash (financial asset)		CU500

To recognise the loan granted to an employee.

^(a) Calculation of the present value of the loan to the employee at the market rate of 7%:

Time	Cash receivable (a)	Discount factor (7%) (b)	Present value (a)x(b)
20X1	20	0.9346	18.69
20X2	520	0.8734	454.19
		Total	472.88

(2) Loan to associate (financial asset)

Since interest is receivable at the market rate of 5%, the entity initially records the loan receivable at the transaction price (that is, CU5,000^(b)).

The journal entries on 1 January 20X1 (initial recognition) are as follows:

Dr	Loan receivable (financial asset)	CU5,000	
	Cr Cash (financial asset)		CU5,000

To recognise the loan granted to an associate.

Since interest on the loan is charged at the market rate, the present value of cash receivable from the associate will be equal to the transaction price of CU5,000.

^(b) Calculation of the present value of cash receivable from the associate at the market rate of 5%:

Time	Cash receivable (a)	Discount factor (5%) (b)	Present value (a)x(b)
20X1	250	0.9524	238.09
20X2	250	0.9070	226.76
20X3	250	0.8638	215.96
20X4	5,250	0.8227	4,319.19
		Total	5,000.00

Module 11—Basic Financial Instruments

(3) Three-year fixed rate bank loan (financial liability)

Since interest is payable at the market rate of 6%, the entity initially records the loan receivable at the transaction price (that is, CU10,000^(c)) less transaction fees of CU100. Hence on 1 January 20X1 the loan will be recognised at CU9,900.

The journal entries on 1 January 20X1 (initial recognition) are as follows:

Loan

Dr	Cash (financial asset)	CU10,000	
	Cr Loan (financial liability)		CU10,000

To recognise the receipt of the proceeds of a loan and the obligation to repay the loan.

Transaction fees

Dr	Loan (financial liability)	CU100	
	Cr Cash (financial asset)		CU100

To recognise borrowing costs.

Since interest on the loan is charged at the market rate, the present value of cash payable to the bank will be equal to the transaction price of CU10,000.

^(c) Calculation of the present value of cash payable to the bank at the market rate of 6%:

<i>Time</i>	<i>Cash payable (a)</i>	<i>Discount factor (6%) (b)</i>	<i>Present value (a)x(b)</i>
20X1	600	0.9434	566.04
20X2	600	0.8900	534.00
20X3	10,600	0.8396	8,899.96
		Total	<u>10,000.00</u>

(4) Overdraft (financial liability)

Since the overdraft is repayable on demand, the entity will recognise the undiscounted amount repayable of CU500.

The journal entries on 1 January 20X1 (initial recognition) are as follows:

Dr	Inventories (asset)	CU500	
	Cr Overdraft (financial liability)		CU500

To recognise the acquisition of inventories.

Module 11—Basic Financial Instruments

Answer to Case Study 2—Part B

(1) *Loan to employee*

The journal entries in 20X1, excluding those on initial recognition are:

Interest receivable

Dr	Loan (financial asset)	CU33.10 ^(d)	
	Cr Profit or loss—interest income		CU33.10

To recognise interest income for the period.

Cash received

Dr	Cash (financial asset)	CU20 ^(d)	
	Cr Loan receivable (financial asset)		CU20

To derecognise a financial asset.

At 31 December 20X1 the loan receivable from the employee has a carrying amount of CU485.98^(d).

Assuming the employee repays the loan as expected on 31 December 20X2, the journal entries in 20X2 are:

Interest receivable

Dr	Loan receivable (financial asset)	CU34.02 ^(d)	
	Cr Profit or loss—interest income		CU34.02

To recognise interest income for the period.

Cash received

Dr	Cash (financial asset)	CU520 ^(d)	
	Cr Loan receivable (financial asset)		CU520

To derecognise a financial asset.

At 31 December 20X2 the loan receivable from the employee has a carrying amount of CU0^(d) (that is, the loan receivable is derecognised as the contractual rights to the cash flows from it are fully settled by the employee on 31 December 20X2).

^(d)The amortised cost calculation is as follows:

Time	Carrying amount at 1 January (A)	Interest at 7%* (B)	Cash inflow (C)	Carrying amount at 31 December (A)+(B)+(C)
20X1	472.88	33.10	(20)	485.98
20X2	485.98	34.02	(520)	–

* The effective interest rate of 7% is the rate that discounts the expected cash flows on the loan receivable to the initial carrying amount of CU472.88.

Module 11—Basic Financial Instruments

(2) Loan to associate

The financial difficulty of the associate and the related restructuring are indicators that the loan receivable is impaired. The impairment loss is the difference between the carrying amount of the loan receivable and the present value of estimated cash flows discounted at the asset's original effective interest rate of 5%^(e) calculated at 31 December 20X1.

On 31 December 20X1 the carrying amount of the loan receivable is CU5,250 (CU5,000^(e) plus the CU250 of interest not paid in 20X1 as expected).

Because of the restructuring, on 31 December 20X1 the present value of revised estimated cash flows discounted at the asset's original effective interest rate of 5% is CU4,535.15^(f).

Therefore, an impairment loss of CU714.85 (that is, CU5,250 less CU4,535.15) is recognised in profit or loss for 20X1.

The journal entries in 20X1, excluding those on initial recognition, are:

Dr	Loan receivable (financial asset)	CU250	
	Cr Profit or loss—interest income		CU250
	<i>To record interest earned in 20X1.</i>		

Dr	Profit or loss—impairment loss	CU714.85	
	Cr Loan receivable (financial asset)		CU714.85
	<i>To recognise the impairment of the loan receivable (capital and interest) to its recoverable amount of CU4,535.15 on 31 December 20X1.</i>		

The journal entries in 20X2 are:

Dr	Loan receivable (financial asset)	CU226.76 ^(g)	
	Cr Profit or loss—interest income		CU226.76
	<i>To record interest earned in 20X2.</i>		

No cash is paid in 20X2. At 31 December 20X2 the loan receivable from the associate has a carrying amount of CU4,761.91^(g):

^(e)The original amortised cost calculation at 1 January 20X1 is as follows:

Time	Carrying amount at 1 January	Interest at 5%*	Cash inflow	Carrying amount at 31 December
20X1	5,000	250	(250)	5,000
20X2	5,000	250	(250)	5,000
20X3	5,000	250	(250)	5,000
20X4	5,000	250	(5,250)	–

* The effective interest rate of 5% is the rate that discounts the expected cash flows on the loan receivable to the initial carrying amount of CU5,000.

Module 11—Basic Financial Instruments

^(f)The present value of estimated cash flows discounted at the asset's original effective interest rate of 5% is CU4,535.15 (see calculation below):

Time	Cash receivable	Original discount factor (5%)	Present value
20X2	–	0.9524	–
20X3	–	0.9070	–
20X4	250.00	0.8638	215.96
20X5	250.00	0.8227	205.68
20X6	250.00	0.7835	195.88
20X7	5,250.00	0.7462	3,917.63
		Total	4,535.15

^(g)The revised amortised cost calculation at 1 January 20X2 is as follows:

Time	Carrying amount at 1 January	Interest at 5%*	Cash inflow	Carrying amount at 31 December
20X2	4,535.15	226.76	–	4,761.91
20X3	4,761.91	238.09	–	5,000.00
20X4	5,000.00	250.00	(250.00)	5,000.00
20X5	5,000.00	250.00	(250.00)	5,000.00
20X6	5,000.00	250.00	(250.00)	5,000.00
20X7	5,000.00	250.00	(5,250.00)	–

*The effective interest rate of 5% is the rate that discounts the expected cash flows on the loan receivable to the initial carrying amount of CU4,535.15.

(3) *Three-year fixed rate bank loan*

The journal entries in 20X1, excluding those on initial recognition are:

Interest expense

Dr	Profit or loss—interest expense	CU631.30 ^(h)	
	Cr Loan (financial liability)		CU631.30

To record interest expense accrued in 20X1.

Cash payable

Dr	Loan (financial liability)	CU600 ^(h)	
	Cr Cash (financial asset)		CU600

To recognise the settlement of a financial liability.

At 31 December 20X1 the loan has a carrying amount of CU9,931.30^(h).

The journal entries in 20X2:

Interest expense

Dr	Profit or loss—interest expense	CU633.29 ^(h)	
	Cr Loan (financial liability)		CU633.29

To record interest expense accrued in 20X2.

Cash payable

Dr	Loan (financial liability)	CU600 ^(h)	
	Cr Cash (financial asset)		CU600

To recognise the settlement of a financial liability.

Module 11—Basic Financial Instruments

At 31 December 20X1 the loan has a carrying amount of CU9,964.59^(h).

^(h)The amortised cost calculation is as follows:

Time	Carrying amount at 1 January	Interest at 6.377%*	Cash outflow	Carrying amount at 31 December
20X1	9,900.00	631.30	(600.00)	9,931.30
20X2	9,931.30	633.29	(600.00)	9,964.59
20X3	9,964.59	635.41	(10,600.00)	—

*The effective interest rate of 6.377% (rounded) is the rate that discounts the expected cash flows on the loan receivable to the initial carrying amount of CU9,900.

(4) Overdraft

The journal entries in 20X1, excluding those on initial recognition are:

Purchases

Dr	Inventories (asset)	CU400	
	Cr Overdraft (financial liability)		CU400

To recognise the purchase of inventories.

Interest expense

Dr	Profit or loss—interest expense	CU44	
	Cr Overdraft (financial liability)		CU44

To recognise interest expense accrued in 20X1.

At 31 December 20X1 the overdraft has a carrying amount of CU944 (that is, CU500 + CU400 + CU44).

The overdraft is not discounted as it is repayable on demand.

The journal entries in 20X2 are:

Purchases

Dr	Inventories (asset)	CU300	
	Cr Overdraft (financial liability)		CU300

To recognise the purchase of inventories.

Interest expense

Dr	Profit or loss—interest expense	CU55	
	Cr Overdraft (financial liability)		CU55

To record interest expense accrued in 20X2.

At 31 December 20X2 the overdraft has a carrying amount of CU1,299 (that is, CU944 + CU300 + CU55).

The overdraft is not discounted as it is repayable on demand.

Module 11—Basic Financial Instruments

(5) Variable rate bank loan

Since interest is payable at the market rate for this type of loan, the loan is recorded by the entity at the transaction price of CU5,000 on 1 January 20X0, because the transaction price will approximate the present value of the future payments discounted at the market rate.

The journal entries in 20X1, excluding those on initial recognition are:

Dr	Profit or loss—interest expense	CU250	
	Cr Cash (financial asset)		CU250

To record interest expense accrued in 20X1 (that is, $CU5,000 \times 5\%$ ⁽ⁱ⁾).

At 31 December 20X1 the loan has a carrying amount of CU5,000. The loan is initially recognised at CU5,000, which is equal to the principal payable on maturity. Therefore, re-estimating the future interest payments will have no significant effect on the carrying amount of the loan (see paragraph 11.19). Cash flows over the life of the loan will constantly vary as EURIBOR varies. However, because interest is charged at the market rate for this type of loan, if the effective interest rate is set to EURIBOR plus 200 basis points it will at any time always exactly discount estimated future cash payments over the remaining loan term to CU5,000. Hence the carrying amount of the loan throughout the four years is CU5,000.

The journal entries in 20X2 are:

Dr	Profit or loss—interest expense	CU225	
	Cr Cash (financial asset)		CU225

To recognise interest expense accrued in 20X2 (that is, $CU5,000 \times 4.5\%$ ⁽ⁱ⁾).

At 31 December 20X1 the loan has a carrying amount of CU5,000.

⁽ⁱ⁾ During 20X1 EURIBOR is a weighted average of 3% and therefore the weighted average interest on the loan is 5% (that is, 3% plus 200 basis points)

⁽ⁱ⁾ During 20X2 EURIBOR is a weighted average of 2.5% and therefore the weighted average interest on the loan is 4.5% (that is, 2.5% plus 200 basis points)

Module 11—Basic Financial Instruments

Answer to case study 2—Part C

[Extract from] Entity A group notes for the year ended 31 December 20X2

Note 1 Accounting policies

Financial instruments

Entity A accounts and reports financial instruments in accordance with the provisions of both Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of the IFRS for SMEs Standard. In the current reporting period and for the comparative period presented, all of the entity's financial assets and financial liabilities satisfied the criteria to be accounted for in accordance with Section 11.

Loans receivable

Entity A occasionally provides its associates or employees with loans. Loans receivable are initially measured at the transaction price plus transactions costs if the interest charged is at the market rate. However, if the employee or associate is not required to pay interest at the market rate, the loan is initially measured at the present value of the future payments discounted at the market rate of interest. Thereafter, such borrowings are measured at amortised cost using the effective interest method. Interest income is included in other income.

At the end of each reporting period, the carrying amounts of loans receivable are reviewed to determine whether there is any objective evidence of impairment. If objective evidence of impairment is found, an impairment test is performed and, if impaired, an impairment loss is recognised immediately in profit or loss with a corresponding decrease in the carrying amount of loans receivable.

Bank loans

Borrowings are initially measured at the transaction price less transactions costs. Thereafter, such borrowings are measured at amortised cost using the effective interest method. Interest expense is recognised on the basis of the effective interest method and is included in finance costs.

Overdrafts

Overdrafts are repayable in full on demand and are initially measured and subsequently measured at face value (that is, the principal amount of the loan at the end of the reporting period).

Note 8 Other income

	20X2	20X1
	CU	CU
Interest income ^(a)	261	283

Module 11—Basic Financial Instruments

Note 9 Finance costs

	20X2	20X1
	CU	CU
Interest on bank overdraft and loans ^(r)	913	925

Note 10 Profit for the year

	20X2	20X1
	CU	CU
Impairment of loan to associate	–	715

Note 14 Carrying amounts of financial assets and financial liabilities in Entity A's statement of financial position at 31 December 20X2

	Note	20X2	Total	20X1
			CU	Total
			CU	CU
<u>Financial assets</u>				
Investments in equity instruments			X	X
Loans receivable	25		4,762	5,021
Trade receivables			X	X
Total			X	X
<u>Financial liabilities</u>				
Trade and other payables			X	X
Overdraft	26		1,299	944
Bank loans	26		14,965	14,931
Total			X	X

Module 11—Basic Financial Instruments

Note 25 Loans receivable

	20X2	20X1
	CU	CU
Loan to employee	–	486
Loan to associate	4,762	4,535
Total	<u>4,762</u>	<u>5,021</u>

The loan to the associate is repayable in full in 20X7. Interest is charged at 5% of the principal amount from 20X4 to 20X7. The entity has provided the associate with an interest-free period until 20X4. On 31 December 20X1, because the associate unexpectedly experienced financial difficulties, the terms of the loan were restructured. Before the restructuring interest was payable at 5% per year and the loan was repayable in full on 31 December 20X4.

Note 26 Bank overdrafts and loans

	20X2	20X1
	CU	CU
Bank overdraft	1,299	944
Fixed-rate bank loan	9,965	9,931
Variable-rate bank loan	5,000	5,000
Total	<u>16,264</u>	<u>15,875</u>

The bank overdraft is repayable on demand. Interest is payable on the bank overdraft at EURIBOR plus 250 points. The overdraft limit is CU2,000 and any outstanding amount must be fully repaid by 31 December 20X6.

The fixed-rate bank loan is repayable in full on 31 December 20X3. Interest is payable yearly in arrears at 6% (20X1: 6%) of the principal amount.

The bank overdraft and fixed-rate loan are secured by a floating lien over land and buildings owned by the entity with a carrying amount of CU56,000 at 31 December 20X2 (CU42,000 at 31 December 20X1).

The variable-rate loan is repayable in full on 31 December 20X4. Interest is payable at EURIBOR plus 200 points (20X1: EURIBOR plus 200 points).

The calculations and explanatory notes below do not form part of the answer to this case study:

^(a) Interest income on loan to employee and loan to associate:

20X1: CU33.10 + CU250 = CU283.10

20X2: CU34.02 + CU226.76 = CU260.78

^(r) Finance costs:

20X1: CU631.30 + CU44 + CU250 = CU925.30

20X2: CU633.29 + CU55 + CU225 = CU913.29