IFRS®
Accounting

Educational Module 11
Financial Instruments

IFRS for SMEs®
Accounting Standard

Third Edition

International Accounting Standards Board

IFRS® Foundation
Supporting Material for the
IFRS for SMEs® Accounting Standard

including the full text of
Section 11 *Financial Instruments*
of the *IFRS for SMEs* Accounting Standard issued by
the International Accounting Standards Board in February 2025

with extensive explanations, self-assessment questions and case studies

This document is not part of the *IFRS for SMEs* Accounting Standard or IFRS Accounting Standards and does not add to or otherwise change the requirements in the Standards. It was developed to aid stakeholders' understanding of our Standards. Views expressed in the document do not necessarily reflect those of the International Accounting Standards Board or the IFRS Foundation. The document should not be relied upon as professional or investment advice.

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The contents of Section 11 *Financial Instruments* of the *IFRS for SMEs* Accounting Standard are set out in this module and shown in grey. The Glossary of terms of the *IFRS for SMEs* Accounting 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.

This module has been prepared by International Accounting Standards Board (IASB) technical staff. The educational notes and examples inserted by the staff are not shaded. These educational notes and examples do not form part of the *IFRS for SMEs* Accounting Standard and have not been approved by the IASB.

INTRODUCTION

IFRS for SMEs® Accounting Standard

The *IFRS for SMEs* Accounting Standard (Standard) is intended for use by small and medium sized entities that publish general purpose financial statements and that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The objective of general purpose financial statements is to provide information about an entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

More information about the Standard and its supporting materials is available on the IFRS Foundation website: www.ifrs.org.

This module

This educational module supports the requirements for accounting and reporting of financial instruments in accordance with Section 11 *Financial Instruments* of the *IFRS for SMEs* Accounting Standard.
The module:

(a) provides explanations and examples to improve understanding of the requirements in Section 11;

(b) identifies the significant judgements required to account for and report financial instruments and transactions;

(c) includes questions to test your understanding of the requirements in Section 11; and

(d) includes case studies that provide a practical opportunity to apply the Section 11 requirements.

After completing the module, you should 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 Part I and Part II 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;
- 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 the types of transactions to which an SME may apply hedge accounting and be able to apply hedge accounting to those scenarios;
- explain when to derecognise financial assets and financial liabilities and demonstrate how to account for such derecognition;
- prepare disclosure of information about financial instruments that could satisfy the disclosure requirements in Section 11; and
- demonstrate an understanding of some of the significant judgements that are required in accounting for financial instruments.

Which version of the Standard does the module refer to?

Any reference in this module to 'the *IFRS for SMEs* Accounting Standard' is to the third edition of the Standard, issued February 2025.

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 that is useful to existing and potential investors, lenders and other creditors when making decisions relating to providing resources to the entity.

Section 11 *Financial Instruments* sets out 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.

Part I of Section 11 applies to basic financial instruments. Part II of Section 11 applies to other, more complex financial instruments and transactions.

What has changed in the third edition of the Standard?

The following are the changes in the third edition of the Standard relating to the requirements for financial instruments:

- The requirements in the previous Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues* have been combined into one section and renamed Section 11 *Financial Instruments*. The requirements in the previous Section 12 have been included as Part II *Other Financial Instrument Issues* of Section 11.
- The option to apply the recognition and measurement requirements in IAS 39 *Financial Instruments: Recognition and Measurement* has been removed.

- Amendment to exclude from the scope of Part II of Section 11 financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group, and to specify that other issued financial guarantee contracts are in the scope of Part II of Section 11 (see paragraphs 11.6(g) and 11.49(k)).
- Clarification that debt instruments that have prepayment features with negative compensation payments can still meet the criteria to be measured at amortised cost (see paragraph 11.9(b)).
- Addition of a supplementary principle for classifying debt instruments based on their contractual cash flow characteristics (see paragraph 11.9ZA).
- Clarification of the reclassification requirements for financial instruments (see paragraph 11.11A).
- Consequential amendments to the initial measurement requirements in Section 11 arising from the revised Section 23 *Revenue from Contracts with Customers* (see paragraphs 11.13–11.13A).
- Relocation to Section 11 from Section 23 of the requirements for the recognition of dividends in profit and loss (see paragraphs 11.14A and 11.55).
- Relocation to the new Section 12 of the requirements for estimating fair value and disclosing information about fair value measurements (see paragraphs 11.27–11.32).
- Addition of requirements to disclose an analysis of the age of financial assets and a maturity analysis of financial liabilities (see paragraphs 11.43–11.43B).
- Consequential amendment to the scope of Section 11 for contracts for contingent consideration in a business combination arising from the revised Section 19 *Business Combinations and Goodwill* (see paragraph 11.49(g)).

Transition requirements are explained in pages 178–179.

REQUIREMENTS AND EXAMPLES

Definitions

The following definitions are reproduced from the Glossary:

A **contract asset** is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

A **contract liability** is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

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.

A **financial asset** is 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; or

(d) a contract that will or may be settled in the entity's own equity instruments and:

  (i) under which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

  (ii) that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A **financial liability** is 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; or

(b) a contract that will or may be settled in the entity's own equity instruments and:

   (i) under which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

   (ii) will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A **financial guarantee contract** is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Equity is the residual interest in the assets of the entity after deducting all its liabilities. Section 22 *Liabilities and Equity* establishes requirements for classifying financial instruments as either liabilities or equity.

Notes on definitions

Financial instruments arise from rights and obligations under contracts. The terms 'contract' and 'contractual' refer to an agreement between two or more parties which creates enforceable rights and obligations. Many rights are established by contract, legislation or similar means. For example, an entity might obtain rights from owning a debt instrument or an equity instrument (see paragraph 2.47). Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed (see paragraph 2.51). 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.

Scope of this section

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

11.2 [Deleted]

Educational notes

It is a common misconception that financial instruments appear only in the financial statements of banks and insurance entities, both of which are often outside the scope of the *IFRS for SMEs* Accounting Standard (see paragraphs 1.2 and 1.3). This is incorrect; 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 Part I of Section 11.

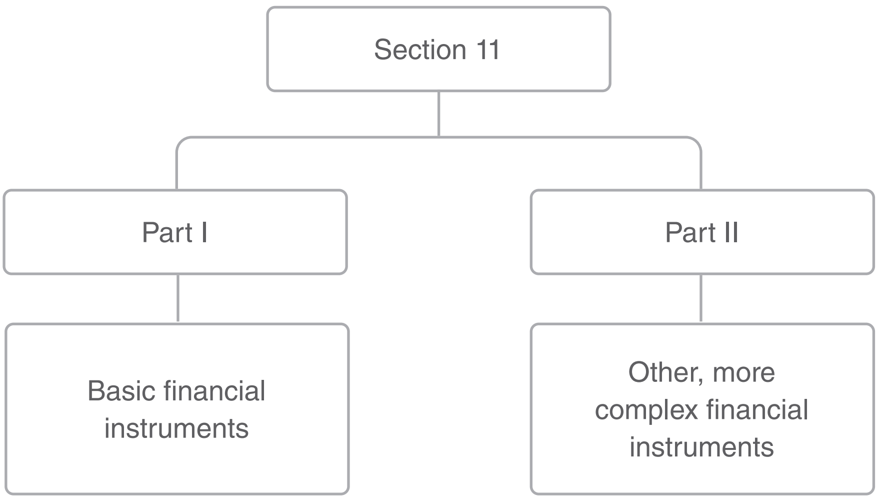
Few SMEs enter into more complex financial instrument transactions, such as transactions involving hedging instruments, futures and options; therefore, the requirements for complex financial instruments do not apply to these SMEs. The requirements for accounting for financial instruments are therefore split into two parts (as shown in Figure 1):

(a) Part I of Section 11 *Basic Financial Instruments*; and

(b) Part II of Section 11 *Other Financial Instrument Issues*.

Part I of Section 11 sets out the requirements for basic financial instruments involving financial instruments that SMEs typically enter into. Part II of Section 11 sets out the requirements for all other financial instruments that fewer SMEs enter into and are generally more complex. SMEs must decide if they need to apply Part II of Section 11: that is, an SME must ensure none of its financial instruments are in the scope of Part II of Section 11. Even entities that normally engage in only basic transactions may occasionally enter into the more complex transactions in the scope of Part II of Section 11. See paragraph 11.11 for examples of financial instruments that are within the scope of Part II of Section 11.

Figure 1: Scope of Section 11



Part I of Section 11
Basic Financial Instruments

Introduction to Part I of 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.

Educational notes

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:

Financial asset—contractual right	*Financial liability—contractual obligation*
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 SME a five-year loan. The bank also provides the SME with an overdraft facility for a number of years.

The SME 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 SME 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 SME under the loan and overdraft facility are financial assets of the bank.

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

SME B: The preference shares may be classified as equity instruments or financial liabilities of SME B, depending on their terms and conditions (see Section 22).

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

Ex 3 **SME A (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 **SME A purchases a subsidiary from SME B. Under the agreement, SME A pays the purchase price in two instalments—CU5 million upfront and a further payment (which is not a contingent payment) of CU5 million in two years.**[1]

The CU5 million payable in two years is a financial liability of SME 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 SME 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 SME 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 paragraph 11.3 and is not a financial liability. The requirements for income tax are in Section 29 *Income Tax*.

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

Ex 6 **Every year for the past 20 years a catering SME has paid CU50,000 towards the costs of the carnival in the village in which the SME operates. The SME 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 SME 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 SME entered into a contract to pay CU50,000 towards the village carnival, then the SME has a financial liability.

Ex 7 **In a lawsuit brought against an SME, 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 SME's production process. It is unclear whether the SME is the source of the contamination because 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 SME because there is no contract between the SME and the affected group of people. The SME will need to consider providing for the payment, applying Section 21.

Ex 8 **An SME 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.**

These fines do not arise from contracts. They are levied because of breaches of statutory requirements, and therefore, are not financial liabilities of the SME. Because the SME must pay the fines, the SME 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 may be within the scope of Section 21.

Ex 9 **An SME acquires a licence 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 SME 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 SME sells goods to customers. The law in the SME's jurisdiction requires that the entity provides a one-year warranty to repair or replace any defective products.

The warranty obligation is not a financial liability because the settlement of the warranty is a service (repair) or good (replacement). The customers have a statutory right to demand repair or replacement of defective products. The warranty provision is in the scope of Section 21 *Provisions and Contingencies*.

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

Paragraph 11.7(c) of Section 11 excludes from the scope leases to which Section 20 *Leases* or paragraph 11.49(f) applies. 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 in regard to individual payments currently due and payable (for example, an amount due in payment for a lease period that has already passed).

Ex 13 An SME 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 SME 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 SME a sum of money upon the death or terminal illness of the owner-manager of the SME. Under the contract, the SME 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 Part I of Section 11.

Scope of Part I of Section 11

11.7 Part I of Section 11 applies to all financial instruments meeting the conditions of paragraph 11.8 except for the following:

(a) interests in **subsidiaries** and **associates** and **joint arrangements** that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Joint Arrangements*.

(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 11.49(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 (see paragraph 21.9).

(g) rights and obligations within the scope of Section 23 *Revenue from Contracts with Customers* that are financial instruments, except for trade receivables that meet the conditions in paragraph 11.8(b).

11.7A The impairment requirements in paragraphs 11.21–11.26 apply to **contract assets**.

Educational notes

All interests in subsidiaries, associates and joint arrangements that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Joint Arrangements* respectively are outside the scope of Section 11 even though the equity shares or other instruments representing those interests are financial instruments.

Section 22 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).

Finance leases result in financial instruments. A finance lease is regarded as a right 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 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.

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.

Section 23 has specific requirements for rights and obligations related to revenue, such as contract assets and contract liabilities. These are outside of the scope of Section 11 (except for the impairment requirements of Section 11, which are applicable to contract assets). However, trade receivables that meet the condition in paragraph 11.8(b) are within the scope of Part I of Section 11.

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance) (see Glossary). For example, an entity is contracted to construct a house for a customer. The entity has an unconditional right to the consideration when 50% of the house is built. Before reaching this 50% mark, the entity has a contract asset for work done to date. Contract assets are recognised and measured in accordance with Section 23; however, contract assets are also subject to the impairment requirements (paragraphs 11.21–11.26) in Part I of Section 11.

Example—subsidiaries, associates and jointly controlled entities

Ex 15 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, Section 14 and Section 15 respectively.

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 assess 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.

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 16 SME 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 SME A as payment for its services.

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

Basic financial instruments

11.8 An entity shall account for the following financial instruments as basic financial instruments in accordance with Part I of 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 or paragraph 11.9ZA;

(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.

Educational notes

A debt instrument is a contractual or written promise 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 Part I of Section 11, a debt instrument must meet the requirements in paragraph 11.9 or paragraph 11.9ZA.

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 Part II of Section 11.

To fall within the scope of Part I 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 Part I 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 Part II of Section 11.

Investments in puttable ordinary or preference shares and in convertible preference shares are outside the scope of Part I of Section 11. They are accounted for in accordance with Part II of Section 11, unless they are investments in subsidiaries, associates or jointly controlled entities that are accounted for in accordance with Sections 9, 14 or 15 respectively (see paragraph 11.7(a)).

An example of what would commonly fail the simplicity test in paragraph 11.8. is derivatives. They are consequently outside the scope of Part I 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 Part II of Section 11 unless they meet the definition of an entity's own equity (see Section 22 and Section 26).

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 and the principle in paragraph 11.9ZA 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 Part I of Section 11.

A derivative embedded in a contract will cause the whole financial instrument to fall outside the scope of Part I of Section 11 and within the scope of Part II of Section 11.

However, exceptions apply—for example, instruments specifically excluded from Part II of Section 11 in accordance with paragraph 11.49(b)–(f).

The following are examples of financial instruments that are likely to be complex and therefore within the scope of Part II of Section 11:

- 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).

Examples—basic financial instruments

Ex 17 An SME has cash.

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

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

Ex 18 **SME A owns 0.5% of the non-puttable ordinary shares that carry voting rights at a general meeting of shareholders of SME B.**

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

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

Example—commitment to receive a loan

Ex 19 **In order to finance the construction of a new office building, an SME takes a loan from a bank. In accordance with the terms of the loan agreement the SME is committed to receiving a loan from the bank in 12 equal consecutive monthly instalments. The SME 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 Part I of Section 11—it meets the conditions in paragraph 11.8(c).

11.9 A debt instrument that satisfies all of the conditions in (a)–(d) shall be accounted for in accordance with Part I of 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 Sterling Overnight Indexed Average (SONIA)); or

(iv) some combination of such fixed 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. A party may pay or receive reasonable compensation on early termination of a contract and still meet this condition.

(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).

11.9ZA A debt instrument that does not meet all of the conditions in paragraph 11.9(a)–(d) shall nevertheless be accounted for in accordance with Part I of Section 11 if the contractual terms of the instrument give rise on specified dates to **cash flows** that are solely payments of principal and interest on the outstanding principal amount. A debt instrument with contractual terms that introduce exposure to unrelated risks or volatility—for example, changes in equity prices or commodity prices—is unlikely to meet this requirement. For the purpose of the requirement in this paragraph, 'interest' includes reasonable compensation for the time value of money, credit risk and other basic lending risks and costs—for example, liquidity risk, administrative costs associated with holding the instrument and lender's profit margin—consistent with a basic lending arrangement.

Educational 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, the principle in paragraph 11.9ZA needs to be considered. If the debt instrument meets the principle in paragraph 11.9ZA, then the debt instrument is within the scope of Part I of Section 11. If a debt instrument does not satisfy the criteria in paragraph 11.9 and principle in paragraph 11.9ZA, it is accounted for in accordance with Part II of Section 11 and measured at fair value through profit or loss.

If the contractual cash flows of a debt instrument that is a financial asset 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 be measured at cost or amortised cost in accordance with Part I of Section 11.

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

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, the credit risk and other basic lending risks and costs associated with the instrument.

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, SONIA, the debt instrument will not meet the criteria in paragraph 11.9 or paragraph 11.9ZA and will be accounted for at fair value in accordance with Part II of Section 11.

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. 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 or prior periods if the debtor is unable to make payment due to financial difficulties, this is not a contractual provision and would not prevent an instrument from meeting the condition in paragraph 11.9(b). Similarly, early termination of a contract does not prevent an instrument from meeting the condition in paragraph 11.9(b).

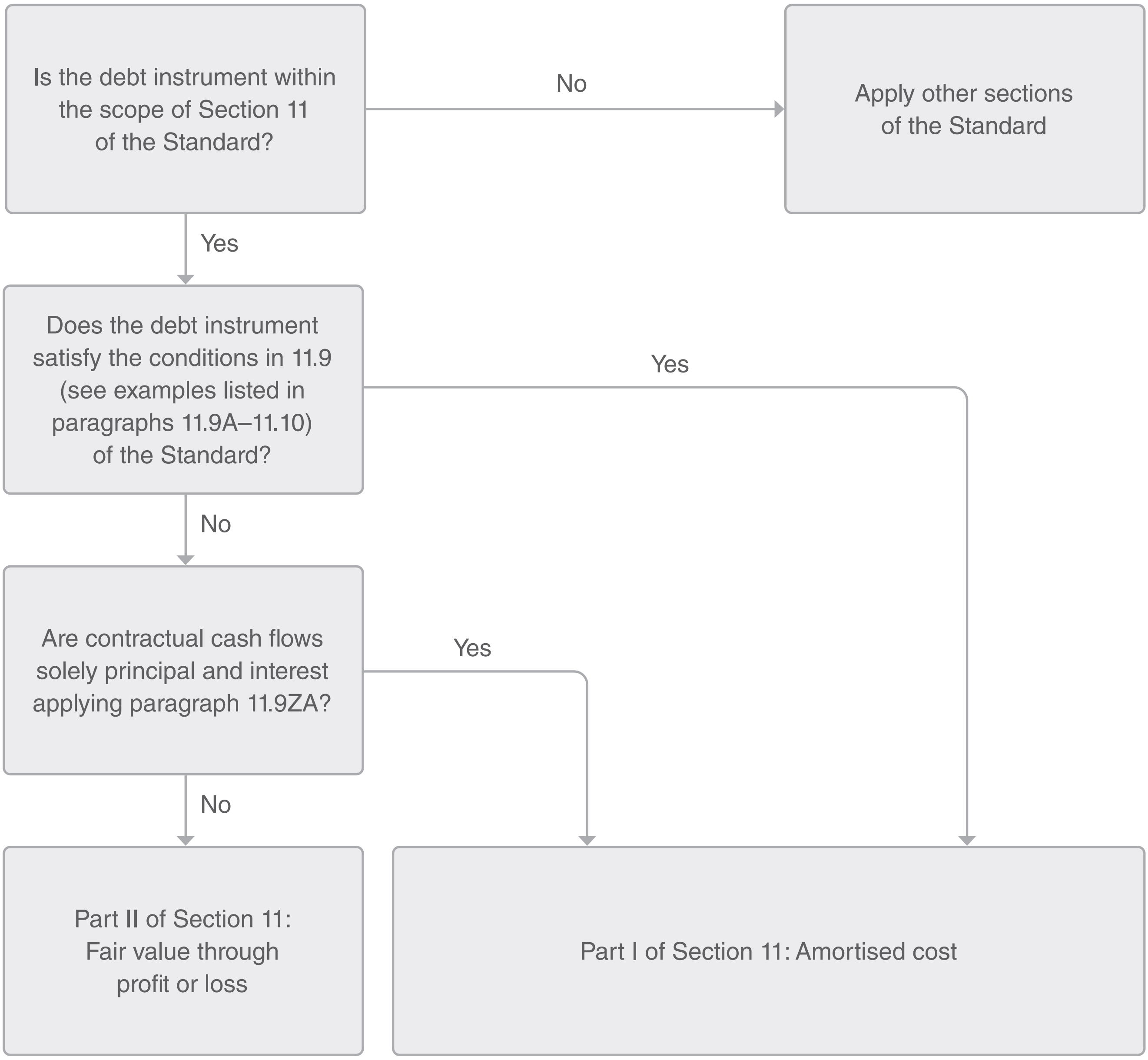
An option for a debtor to choose to prepay a debt instrument (for example, a loan) will not necessarily prevent an instrument from satisfying the requirements in paragraph 11.9 (see paragraph 11.9(c)). To satisfy the requirement in paragraph 11.9(c), the prepayment amount must be substantially equal 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 Part II of Section 11. Such contingent future events must be considered uncertain when the contract is signed, 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 be accounted for in accordance with Part I of Section 11 (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 prevent an instrument from meeting the conditions in paragraph 11.9(a).

The principle for classification of financial instruments in paragraph 11.9ZA needs to be considered if a debt instrument (financial asset or financial liability) does not match any of the examples in paragraphs 11.9–11.11. Figure 2 shows how paragraph 11.9ZA is applied.

Figure 2: Classification and measurement of financial instruments



Example—insurance contract

Ex 20 **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 the scope of Part I of Section 11. Normally these rights are also outside the scope of Part II of Section 11 because of the exception in paragraph 11.49(d). If the rights are outside the scope of Section 11 the following apply:

- any contingent assets should be accounted for applying Section 21;
- 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 applying Section 21; and
- the SME must use its judgement to develop an accounting policy for any further assets resulting from those rights (see paragraphs 10.4–10.6).

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 SONIA plus 200 basis points.

11.9B An example of a debt instrument that would normally satisfy the conditions set out in paragraph 11.9(b)–(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).

11.11 Examples of financial instruments that do not satisfy the conditions in paragraph 11.9 or 11.9ZA (and are therefore within the scope of Part II of Section 11) 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—satisfying the conditions in paragraph 11.9

Ex 21 SME 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 20X4.

The debt instrument is a trade payable (financial liability) of SME A.

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 Part I of Section 11 by SME A. The debt instrument is included as an example in paragraph 11.10(a) of a financial instrument that would normally satisfy the conditions in paragraph 11.9.

Ex 22 SME A owes SME B CU950 for 95 items purchased at CU10 per item on credit from SME B. SME 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. SME A buys five more items and the total amount payable is therefore CU900.

The debt instrument is a trade payable (financial liability) of SME A and a trade receivable (financial asset) of SME B.

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 Part I of Section 11 by both SME A and SME B. The debt instrument is included as an example in paragraph 11.10(a) of a financial instrument that would normally satisfy the conditions in paragraph 11.9.

Ex 23 **An SME holds a 10-year treasury bond (that is, a government bond) with a fixed coupon (the annual interest rate paid on a bond or similar instrument).**

The investment in treasury bonds is a financial asset of the SME.

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 Part I of Section 11. Treasury bonds are a type of debt instrument issued by the government to obtain funding, where the holder (SME) provides a loan to the government and are included in the examples in paragraph 11.10(a).

Ex 24 **Bank A advanced a loan to SME B. The terms of the loan require SME B to pay a variable rate of interest specified as SONIA plus 150 basis points, with interest payments receivable quarterly in arrears for six years.**

The loan is a financial liability of SME B.

The loan 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 Part I of Section 11. The loan is included in the list of examples in paragraph 11.10(a).

Ex 25 **An SME has an overdraft facility. The bank charges interest on any amount overdrawn of SONIA plus 300 basis points.**

The debt instrument is a financial liability of the SME.

The debt instrument 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 Part I of Section 11. The debt instrument is included as an example in paragraph 11.9A(b).

Ex 26 **SME A issues perpetual debt instruments (for example, 'perpetual' bonds) to SME B which provide the holder (SME 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 SME A in accordance with Section 22.**

The debt instrument is a financial liability of SME A and a financial asset of SME 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 Part I of Section 11 by both SMEs. 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 for this type of instrument. The debt instrument is included as an example in paragraph 11.10(d).

Ex 27 **SME A issues mandatorily redeemable preference shares to SME B. These shares have fixed annual dividend payments and a fixed maturity date.**

The preference shares, classified in accordance with Section 22, are financial liabilities of SME A and financial assets of SME B in accordance with Section 11.

For SME 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 Part I of Section 11.

For SME 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 28 **An SME has a fixed-rate mortgage loan from a bank that it used to finance the purchase of its office building. The SME has the contractual right to pay off the mortgage early and would probably do so if market interest rates fell significantly, because the SME would then be able to refinance at a lower rate.**

The mortgage loan is a financial liability of the SME. The mortgage loan satisfies paragraph 11.9(a)—the SME pays a fixed rate of interest on the loan. There is a contractual provision that permits the SME to prepay the mortgage but, because 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 and is accounted for in accordance with Part I of Section 11.

Ex 29 **An SME holds zero-coupon bonds issued by a large corporation at a discount to their par amount (that is, 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 bonds are a financial asset of the SME.

The zero-coupon bond satisfies paragraph 11.9(a), because the SME 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 because it is not contingent on future events paragraph 11.9(c) is satisfied. Any prepayment would not result in the SME losing its principal or any accrued interest because the prepayment must cover amortised cost at any time (that is, paragraph 11.9(b) is satisfied). Provided there are no additional conditional returns or repayment provisions (paragraph 11.9(d)), the zero-coupon bond satisfies the requirements in paragraph 11.9 and is accounted for in terms of Part I of Section 11.

Examples—financial instruments that do not satisfy paragraph 11.9

Ex 30 To invest in a diversified portfolio of shares and bonds with only a small amount of capital, an SME purchased units (sometimes called shares) in a mutual fund.[2] 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 SME (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 SME 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 Part I of Section 11. The investment in the mutual fund is accounted for in accordance with Part II of Section 11.

Ex 31 SME A purchases a subsidiary from SME B. SME A pays CU50,000 upfront and agrees to pay a further CU50,000 to SME B in two years' time if the subsidiary meets specific 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 SME A and a financial asset of SME B.

The contingent consideration does not satisfy the condition in paragraph 11.9(a) or 11.9(d) because the return is conditional, that is, it is neither fixed nor a variable return described in paragraph 11.9(a)(ii). Therefore, the contingent consideration is outside of the scope of Part I of Section 11.

Contingent consideration recognised by an acquirer (financial liability) is listed in paragraph 11.6 as an example of financial instruments that are within the scope of Part II of Section 11 and is measured at fair value through profit or loss. Contingent consideration recognised by the seller (SME B's financial asset) is also accounted for applying Part II of Section 11.

However, if the fair value (after applying the requirements of Section 12 *Fair Value Measurement*) cannot be measured reliably without undue cost or effort, the contingent consideration will be measured applying Section 19 *Business Combinations and Goodwill*.

2 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.

Ex 32 **An SME holds a note receivable that does not charge interest. The note gives the SME (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 SME because the SME 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.

The market value of government bonds fluctuates over time. Hence, the returns to the holder of the note are not fixed or variable based on a single referenced 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.

The SME should consider the principle in paragraph 11.9ZA. The principle in paragraph 11.9ZA is not met as the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. This is because the contractual cash flows reflect a return that is linked to the value of the government bonds.

Because the debt instrument (note receivable) does not satisfy all the conditions in paragraph 11.9 and does not meet the principle in paragraph 11.9ZA, it cannot be accounted for in accordance with Part I of Section 11. It is accounted for in accordance with Part II of Section 11.

Ex 33 **An SME 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, so the debt instrument does not satisfy the condition in paragraph 11.9(a).

The SME considers the principle in paragraph 11.9ZA. The principle in paragraph 11.9ZA is not met because the contractual cash flows are not solely payments of principal and interest on the outstanding principal amount. The contractual cash flows reflect a return that is inconsistent with a basic lending arrangement, because they are linked to the price of oil.

Because the debt instrument does not satisfy the condition in paragraph 11.9(a) and does not meet the principle in paragraph 11.9ZA, it cannot be accounted for in accordance with Part I of Section 11. It is accounted for in accordance with Part II of Section 11.

Ex 34 **An SME guarantees repayment of a loan issued by a bank to one of the SME's associates. A financial guarantee is a contractual right of the lender (bank) to receive cash from the guarantor (SME), 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. The guarantee is a financial asset of the bank and a financial liability of the SME. Because the right is contingent on a future unknown event, the condition in paragraph 11.9(d) is not satisfied. Also, the guarantee 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 also not met. The SME's financial liability does not satisfy all the conditions in paragraph 11.9.

Issued financial guarantee contracts are listed in paragraph 11.6 as an example of financial instruments that are within the scope of Part II of Section 11. Financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group are within the scope of Section 21. A group is a parent and its subsidiaries (see Glossary). The specified debtor in this example is an associate of the SME. Therefore, regardless of consideration of the guarantee, the financial guarantee is in the scope of Part II of Section 11.

Ex 35 An SME guarantees repayment of a loan issued by a bank to one of the SME's subsidiaries and does not charge the subsidiary (for nil consideration). The financial guarantee is a contractual right of the lender (bank) to receive cash from the guarantor (SME), and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower (subsidiary) defaults.

The guarantee provides the bank with a contingent right to cash. The guarantee is a financial asset of the bank and a financial liability of the SME.

Issued financial guarantee contracts are listed in paragraph 11.6 as an example of financial instruments that are within the scope of Part II of Section 11. However, financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group are in the scope of Section 21. A group is a parent and its subsidiaries (see Glossary). The specified debtor in this example is a subsidiary of the SME, and therefore part of the group. Because the guarantee was issued at nil consideration, the financial guarantee is in the scope of Section 21.

Ex 36 A customer takes legal action against an SME for damage the customer states was caused by one of the SME's products. The SME takes out a three-year bank loan to finance the legal fees. There is a contractual provision in the loan contract that if the SME wins the case, the SME may repay the loan early. If the SME is unsuccessful, it cannot repay the loan early.

The loan is a financial liability of the SME. The loan does not satisfy the conditions in paragraph 11.9(c) because the contractual provision that permits the SME 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 cannot be accounted for in accordance with Part I of Section 11. It is accounted for in accordance with Part II of Section 11.

Ex 37 An SME buys a fixed rate interest-only strip on a bond (that is, the SME 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 SME 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 SME. If the issuer of the bond (creditor) chooses to settle the bond early, the SME may not recover its investment because no interest payments will be incurred after settlement of the principal. Because the SME 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.

The SME should consider the principle in paragraph 11.9ZA for the financial asset. The principle in paragraph 11.9ZA is not met because the contractual cash flows are not solely payments of principal and interest on the outstanding principal amount. The contractual cash flows reflect only the interest and not payments of the principal.

The debt instrument does not satisfy the conditions in paragraph 11.9 and the principle in paragraph 11.9ZA. The debt instrument cannot be accounted for in accordance with Part I of Section 11. It is accounted for in accordance with Part II of Section 11.

Ex 38 SME A has an investment in shares in SME B. Embedded within the shares is a put option allowing SME A to sell the shares back to SME B for the higher of the market value of the shares and an amount equal to the initial investment made by SME A plus compounded interest based on market rates. Therefore, SME 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 SME A acquires the shares.

SME A's perspective: The investment (the shares with the embedded put option) in SME B's shares (financial asset) does not satisfy the condition in paragraph 11.8(d)—because the shares are puttable.

If this investment meets the definition of a financial asset but does not satisfy the conditions in paragraph 11.9 or paragraph 11.9ZA, then it is in the scope of Part II of Section 11.

There being a minimal return equal to that on a debt instrument, the instrument would not satisfy paragraph 11.9 because 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, SME A's investment in shares cannot be accounted for in accordance with Part I of Section 11. It is accounted for in accordance with Part II of Section 11.

SME B's perspective: SME B applies Section 22 to determine whether its own shares should be classified as equity, a compound instrument or a financial liability within the scope of Part I or Part II of Section 11.

11.11A An entity shall not reassess the **classification** of a financial instrument after initial **recognition**.

Educational notes

Once a financial instrument is classified at initial recognition, that is, measured at amortised cost or measured at cost less impairment (within the scope of Part I of Section 11) the entity cannot change this classification subsequently. The entity shall assess whether to derecognise the financial instrument in accordance with paragraphs 11.33–11.38.

Example—reassessing classification of a financial instrument

Ex 39 Bank A advanced a loan to SME B. The loan pays a variable rate of interest specified as SONIA plus 150 basis points, with interest payments receivable quarterly in arrears for three years. At the beginning of the second year, Bank A and SME B agree to change the terms of the loan so that the interest payments are indexed to the price of oil.

At initial recognition the loan was classified as being within the scope of Part I of Section 11 by SME B (see Example 24). The subsequent change of terms of the loan results in the loan falling within the scope of Part II of Section 11 (see Example 33). However, applying paragraph 11.11A SME B cannot reassess the classification of the loan.

SME B should assess whether the change in the terms of the loan represents a substantial modification (applying paragraph 11.37).

11.4 Part I of 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.

Educational notes

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

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 entity 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 entity's financial statements (see paragraph 2.29). If an entity 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 entity. 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 2.30). 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 2.31).

11.5 Basic financial instruments within the scope of Part I 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 40 An SME holds commercial paper (an unsecured, short-term debt instrument) issued by a large corporation.

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

Example—bonds

Ex 41 An SME 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 (the annual interest rate paid on a bond) 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 SME are 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 Part II of Section 11, 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 Part II of Section 11;

(d) commitments to make a loan to another entity;

(e) commitments to receive a loan if the commitment can be net settled in cash;

(f) **contingent consideration** recognised by an **acquirer** in a **business combination**; and

(g) issued **financial guarantee contracts**—however, financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the **group** are in the scope of Section 21 *Provisions and Contingencies* (see paragraph 21.1A).

Educational 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 Part I of Section 11 and are accounted for in accordance with Part II of Section 11.

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 Part II of Section 11. 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 then the financial instrument designated as the hedging instrument will fall outside the scope of Part I of Section 11.

Paragraph 11.6(f) refers to contingent consideration recognised by an acquirer in a business combination. Section 19 sets out the requirements for business combinations. Contingent consideration is usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met (see Glossary). The contingent consideration is a financial instrument. However, it does not satisfy the conditions in paragraph 11.8. Therefore, the contingent consideration is within the scope of Part II of Section 11. However, the measurement requirements in Part II of Section 11 only apply to contingent consideration whose fair value can be measured reliably without undue cost or effort (see paragraph 11.49(g)).

An issued financial guarantee contract (paragraph 11.6(g)) is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument (see Glossary). Issued financial guarantee contracts are listed in paragraph 11.6 as an example of financial instruments that are within the scope of Part II of Section 11. However, financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group are included in the scope of Section 21.

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.

Educational notes

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

The following arrangements are not recognised as financial assets and financial 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.

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:

(a) the financial asset is a trade receivable (see paragraph 11.13A); or

(b) 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 (see paragraph 11.13B).

11.13A A trade receivable shall be recognised initially at the amount determined by applying Section 23, unless the arrangement constitutes, in effect, a financing transaction and the entity does not apply the option in paragraph 23.38. For such arrangements, the entity shall measure the trade receivable in accordance with paragraph 11.13B.

11.13B 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 amount determined by applying Section 23, 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 present value of the cash receivable discounted using the prevailing market rate(s) of interest for a similar receivable. The current cash sale price will normally approximate the present value of the cash receivable discounted at the appropriate market rate.

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.

Educational notes

When is an entity required to use present value?

Financial instruments will, on initial recognition, be measured at their transaction price (including transaction costs), unless the financial asset is a trade receivable or the arrangement constitutes, in effect, a financing transaction.

Trade receivables (paragraph 11.13A)

Paragraph 23.80 describes a receivable as an entity's unconditional right to consideration. A right to consideration is unconditional if only the passage of time is necessary before payment of that consideration becomes due. Entities typically invoice customers for consideration to which they have an unconditional right.

An arrangement constitutes a financing transaction if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate. Trade receivables are recognised initially at the amount determined by applying Section 23, unless the arrangement constitutes, in effect, a financing transaction, and the option in paragraph 23.38 is not applied. Paragraph 23.38 provides an entity with an option to not discount if it expects a customer to pay for the goods and services within one year of the entity transferring the goods or services.

Paragraph 11.13B applies to a trade receivable arising from an arrangement which constitutes, in effect, a financing transaction, for which the entity does not apply the option in paragraph 23.38 (see following paragraph on financing transactions). An entity would not apply the option in paragraph 23.38 because it chooses not to or is ineligible to do so.

Financing transactions (paragraph 11.13B)

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 services) 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 or an associate). For such transactions, the entity must initially 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. The similar debt instrument should be similar 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 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. In such a case, the cash sale price will normally approximate the present value of the future payments discounted at the appropriate market rate. The cash sale price is the amount of cash that would need to be paid to buy/sell an asset if the cash is paid upfront, on the date of the sale/purchase.

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 the full amount payable on demand (see Example 54)). 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 (see Glossary). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. 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 determining the amount recognised on initial recognition. For financial liabilities, directly related costs of issuing debt are deducted in determining 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[3] 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 included when determining the amount 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.

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.

3 This educational material includes a number of illustrative journal entries. Please note that these are intended to illustrate one way, not necessarily the only way, in which the journal entries might be structured or processed.

Examples—financial assets

Ex 42 **An SME incurred CU10 broker transaction fees to buy 50 non-puttable ordinary shares in a listed company on the market for cash of CU500.**

The SME 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)(i)) 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 43 **An SME 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)(ii).**

The SME 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 44 **An SME 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 the amount determined by applying Section 23, which is CU200 (that is, the invoice price). The transaction took place under normal business terms and does not constitute a financing transaction. 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.

Ex 45 **An SME deposits CU20,000 into a 120-day notice deposit account with a bank. The SME 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 is measured at the transaction price of CU20,000. 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 46 **The facts are the same as in Example 45. However, in this example, the SME had to pay the bank an upfront administration fee of CU50 to cover paperwork.**

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 47 **On 1 January 20X2 a machine manufacturing SME delivers to a customer a machine for CU2,000 with payment in two years' time. The arrangement constitutes a financing arrangement. On delivery of the machine, the SME has an unconditional right to receive consideration. The current cash sale price for the machine if customers pay on delivery is CU1,650.**

A trade receivable is recognised at the cash sale price of CU1,650 (which approximates the present value of the cash receivable discounted at a market rate of interest for a similar debt instrument). The CU1,650 also represents the amount of revenue recognised in accordance with Section 23 (that is, the discounted amount of promised consideration using the interest for a similar debt instrument).

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 (constituting a finance transaction).

Ex 48 **The facts are the same as in Example 47. 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.**

Because the current cash sale price is not known, the trade receivable is recognised at the present value of the amount receivable discounted using the market rate of interest for a similar debt instrument which is CU2,000 ÷ $(1.1)^2$ = CU1,652.

Ex 49 **An SME 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).**

Because the loan is not at a market interest rate for a similar loan, it is not measured at the transaction price of CU500. Instead the SME 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 ÷ $(1.05)^3$ = CU431.92. Therefore, a financial asset of CU431.92 is recognised 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 69).

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 SME 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.

Ex 50 The facts are the same as in Example 49. However, in this example, the SME 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. The SME 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 ÷ $(1.05)^3$ = CU431.92. Therefore, a financial asset of CU431.92 is recognised 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 69).

The difference between the CU500 and the CU431.92 of CU68.08 is recognised as an expense immediately unless it meets the definition of an intangible asset under Section 18 *Intangible Assets other than Goodwill*. It does not meet the definition of a financial asset because there is no contractual right to receive cash or other financial assets. Even if the customer intends to return additional money to the SME (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 51 On 1 January 20X0 an SME acquires a zero-coupon bond in the market for CU98 in an arm's length transaction. The SME incurs transaction fees of CU2. The bond is redeemable at CU126 on 31 December 20X4.

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 measured at the transaction price. Because 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 five-year period (see Example 74).

Examples—financial liabilities

Ex 52 An SME buys goods from a manufacturer for CU400 with 120 days' interest-free credit, the normal business terms in the industry.

The SME initially recognises a trade payable at CU400 (that is, the undiscounted amount of cash payable). The transaction takes place on normal business terms and is not a 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 53 An SME starts renting an office building for CU1,000 a month on 1 November 20X4. At its year-end (31 December 20X4) the SME has not yet paid any rent. Landlords in the nearby area allow tenants to pay rentals quarterly in arrears.

The SME 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 this is not a 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.

Ex 54 An SME 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 SME does not expect to pay off the amount during the year.

The SME will recognise a financial liability for the overdrawn amount of CU1,500. It is not discounted at a market rate because it is repayable on demand so it is 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.

Ex 55 A bank provides an SME 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 interest rate of 8% is considered the market rate for similar four-year fixed-interest loans with interest paid annually in arrears.

Because interest is payable at a market rate for that type of loan, the SME measures the loan at the transaction price (that is, CU5,000) on initial recognition. 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: Because 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).

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 56 **The facts are the same as in Example 55. However, in this example, the SME obtains the loan after taking advice from a specialist loans broker. The broker charges the SME CU100.**

The loan is initially measured at the transaction price minus the broker fees (that is, CU4,900) on initial recognition. The journal entries are:

<u>**Loan**</u>

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

To recognise the loan.

<u>**Transaction fee**</u>

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

To recognise the transaction 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.

Ex 57 **A bank provides an SME 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 SONIA plus 250 basis points, with interest payments receivable annually in arrears.**

Because interest is payable at a market rate for that type of loan, the loan is measured by the SME at the transaction price (that is, CU5,000) on initial recognition. 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 in obtaining the loan, the loan would be measured at CU4,950 on initial recognition. The journal entry for the transaction fees would be:

<u>**Transaction fee**</u>

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

To recognise the transaction costs.

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

Ex 58 **A bank provides an SME with a five-year loan of CU5,000. The bank charges the SME 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 SME an additional amount (an upfront fee) of CU400, which is considered to compensate the SME for paying a higher rate of interest.**

Because the CU400 is considered to compensate the SME for paying interest above the market rate, the SME is effectively paying a normal market rate to borrow CU5,400. Therefore, the loan is measured 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 to make on subsequent measurement are illustrated in Example 78.

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

Time	*Cash payable (a)*	*Discount factor (8%) (b)*	*Present value (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	3,402.92
			5,399.27

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

Ex 59 **On 1 January 20X4 SME A issues a debt instrument for a price of CU1,250 to an unrelated party. The principal amount is CU1,250 and the repayment date is fixed—31 December 20X8. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6% in 20X4 (CU75), 8% in 20X5 (CU100), 10% in 20X6 (CU125), 12% in 20X7 (CU150) and 16.4% in 20X8 (CU205). The SME 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 SME.

The journal entries to make on subsequent measurement are illustrated in Example 79.

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

Time	*Cash payable (a)*	*Discount factor (10%) (b)*	*Present value (a) x (b)*
20X4	75	0.9091	68.18
20X5	100	0.8264	82.64
20X6	125	0.7513	93.91
20X7	150	0.6830	102.45
20X8	1,455 (205 + 1,250)	0.6209	903.44
			1,250.62

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

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 paragraphs 11.13 and 11.13B). Trade receivables that are classified as current assets shall be measured at the undiscounted amount of the cash or other consideration expected to be received (ie net of impairment) unless the arrangement constitutes, in effect, a financing transaction and the entity does not apply the option in paragraph 23.38.

(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 (Section 12 provides 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). Paragraphs 11.21–11.26 provide guidance.

Examples—financial assets

Ex 60 **An SME 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 SME initially recognised its investment in equity instruments at CU500 (see Example 42). Because the shares are publicly traded, the SME must, after initial recognition, measure the investment at fair value and recognise changes in fair value in profit or loss (see paragraph 11.14(c)(i)).

Therefore, the journal entries are:

<u>**Subsequent measurement**</u>

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.

Ex 61 **An SME 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 SME initially recognised the investment in equity instruments at CU510 (see Example 43).

On subsequent measurement, at year-end, because fair value cannot be measured reliably without undue cost or effort, the SME 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 plus CU10 transaction fees).

Ex 62 **On 15 December 20X5 an SME provided services to a customer and charged the customer CU200 with payment due within 60 days, standard for the industry. At the SME's financial year-end (31 December 20X5) the customer has not yet paid the amount due.**

On 15 December 20X5 the SME initially recognised a trade receivable at CU200 (see Example 44).

The trade receivable is a current asset and is not a 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 20X5 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 63 **An SME buys goods from a manufacturer for CU400 on 1 November 20X6 with 120 days' interest-free credit, which are normal business terms in the industry. At the SME's financial year-end (31 December 20X6) the SME has not yet paid the manufacturer.**

On 1 November 20X6 the SME initially recognised the trade payable at CU400 (see Example 52).

The trade payable is a current liability and because the transaction took place under normal business terms it does not constitute a financing arrangement. Therefore, on subsequent measurement at 31 December 20X6 the trade payable continues to be measured at the undiscounted amount of the cash expected to be paid (that is, CU400).

Ex 64 An SME 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 SME's financial year-end CU2,000 is outstanding on the overdraft. The SME does not expect to pay off the amount during the year.

The SME 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 because it is repayable on demand.

11.14A **Dividends** are recognised in profit or loss only when:

(a) the entity's right to receive payment is established;

(b) it is **probable** that the economic benefits associated with the dividend will flow to the entity; and

(c) the amount of the dividend can be measured reliably.

Educational notes

Dividends are distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital (see Glossary).

Examples—dividends

Ex 65 SME A owns 2% of the ordinary share capital of SME B.

On 18 December 20X4, the management of SME B proposed a dividend of CU1,000,000 for the year ended 31 December 20X4. SME A is not entitled to receive its share of the dividend of CU20,000 until the shareholders of SME B have approved it. The shareholders of SME B will approve the dividend on 28 February 20X5.

On 28 February 20X5, the dividend was approved by the shareholders of SME B at the annual general meeting. The dividend will be paid on 20 May 20X5 to shareholders registered on 28 February 20X5 as owners of SME B's ordinary shares.

Both SME A and SME B have December year-ends.

For the year ended 31 December 20X4, SME A should not recognise the dividend proposed on 18 December 20X4. SME A's right to receive payment of the dividend of CU20,000 is established when the shareholders approve it on 28 February 20X5. Note also that SME B should not recognise a dividend payable until the dividend is approved.

Ex 66 The facts are the same as in Example 65 except that SME A has a March year-end.

In the year ended 31 March 20X5, SME A should recognise dividend of CU20,000 for the dividend proposed on 18 December 20X4 and approved on 28 February 20X5. SME A's right to receive payment is established when the shareholders approved it on 28 February 20X5. In its statement of financial position as at 31 March 20X5, SME A recognises a receivable for the dividend which will be paid on 20 May 20X5.

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.

Educational 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 measured at the transaction price, the effective rate of interest on initial recognition will usually be the market rate (see Examples 69 and 75). However, if there are transaction costs and other premiums or discounts, 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 76).

For financial liabilities, if a creditor may demand repayment at a specific 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 specific date in the future the entity should assume repayment takes place on that date for the purposes of the amortised cost calculation.

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 67 An SME 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 SME expects that the associate will not prepay the loan, the amortisation period is equal to five years.

If at inception the SME expects the associate will 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.

Educational 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 because such costs are not subject to repricing or related to any particular term of the loan.

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

Example—amortisation period

Ex 68 A bank provides an SME 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 SME 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 fee of CU70 is allocated using the effective interest method. One way of doing this is as follows:

	Carrying amount at start of period	*Interest income at 3.695%[(a)]*	*Carrying amount at end of period*
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.

Note: The carrying amount of the loan is CU930 on initial recognition (CU1,000 minus upfront fee 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.

Educational notes

The cash flows that are discounted to determine 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 80 and 81).

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, because 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.

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

On 1 January 20X0, an SME 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)	–

* The effective interest rate of 6.9584% is the rate that discounts the expected cash flows on the bond to the initial carrying amount:
$40 \div (1.069584)^1 + 40 \div (1.069584)^2 + 40 \div (1.069584)^3 + 40 \div (1.069584)^4 + 1{,}140 \div (1.069584)^5 = 950$

Educational 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 minus the estimated future cash payments or receipts through the expected life of the financial instrument discounted at the effective interest rate equals zero.

The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet. The Goal Seek function in Excel is a formula that helps to determine the effective interest rate that results in the present value of future cash flows being equal to the carrying amount at initial recognition.

Examples—financial assets

Ex 69 On 1 January 20X1 an SME 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 SME has a 31 December financial year-end.

On initial recognition the loan receivable was measured by the SME at CU431.92 (see Example 49).

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):

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. However, in this example, because there is only one payment, the effective interest rate can be determined by solving the equation CU431.92 = CU500 ÷ $(1 + X)^3$ where 'X' is the effective interest rate.

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

Ex 70 **The facts are the same as in Example 69. However, in this example, the three-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 × 245 ÷ 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 × 245 ÷ 365 days)).

Ex 71 **The facts are the same as in Example 45: on 1 December 20X1 an SME deposits CU20,000 into a 120-day notice deposit account with a bank. The SME 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 SME (see Example 45).

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

Time	*Carrying amount at 1 December 20X1*	*Interest at 1.644%*[(a)]	*Amount paid at 30 March 20X2*	*Carrying amount at 30 March 20X2*
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 ÷ 1.01644 = CU20,000.

The effective interest rate can be determined by solving the equation CU20,000 = CU20,329 ÷ (1+X) where 'X' is the effective interest rate.

Therefore X = CU20,329 ÷ CU20,000 -1 = 0.01644.

On 31 December 20X1 the SME'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 × 31 ÷ 120 days).

Ex 72 **The facts are the same as in Example 71. However, in this example, the SME paid the bank an upfront administration fee of CU50.**

The deposit is recognised at CU20,050 by the SME on initial recognition (see Example 46).

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

Time	*Carrying amount at 1 December 20X1*	*Interest at 1.392%*[(a)]	*Amount paid at 30 March 20X2*	*Carrying amount at 30 March 20X2*
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 ÷ (1 + X) where 'X' is the effective interest rate.

Therefore X = CU20,329 ÷ CU20,050 – 1 = 0.0139.

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

Ex 73 **Continuing from Example 47, on 1 January 20X2 a machine manufacturing SME delivers to a customer a machine for CU2,000 with payment in two years' time. The arrangement constitutes a financing arrangement. On delivery of the machine, the SME has an unconditional right to receive consideration. The current cash sale price for that item if customers pay on delivery is CU1,650.**

A trade receivable is recognised by the SME at CU1,650 on initial recognition. The subsequent accounting for the transaction is as follows:

Time	*Carrying amount at 1 January*	*Interest at 10.096%*[(a)]	*Cash inflow*	*Carrying amount at 31 December*
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. However, in this example because there is only one payment the effective interest rate can be determined by solving the equation CU1,650 = CU2,000 ÷ $(1 + X)^2$ where 'X' is the effective interest rate.

Therefore $(1 + X)^2$ = CU2,000 ÷ CU1,650, so X = $(CU2,000 ÷ CU1,650)^{½}$ – 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.

Ex 74 On 1 January 20X0 an SME 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 SME on initial recognition (see Example 51).

Time	*Carrying amount at 1 January*	*Interest at 4.73%*[(a)]	*Cash inflow*	*Carrying amount at 31 December*
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. However, in this example because there is only one payment the effective interest rate can be determined by solving the equation CU100 = CU126 ÷ $(1+X)^5$ where 'X' is the effective interest rate.

Therefore $(1 + X)^5$ = CU126 ÷ CU100, so X = $(\text{CU126} \div \text{CU100})^{0.2}$ 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 75 On 1 January 20X1 a bank provides an SME 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 SME has a prepayment option where it can repay the loan in full after two years. The SME 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 interest rate of 8% is considered the market rate for similar two-year fixed-interest loans with interest paid yearly in arrears.

At inception the SME 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).

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

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

Time	*Carrying amount at 1 January*	*Interest at 8%*[(a)]	*Cash outflow*	*Carrying amount at 31 December*
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 ÷ 1.08 + CU5,400 ÷ $(1.08)^2$ = CU5,000. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet.

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 a financial liability.

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

Ex 76 **The facts are the same as in Example 75. However, in this example, the SME obtains the loan after taking advice from a specialist loans broker. The broker charges the SME CU100 for these services.**

On initial recognition, the SME measures the loan at the transaction price minus 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.

Time	*Carrying amount at 1 January*	*Interest at 9.139%*[(a)]	*Cash outflow*	*Carrying amount at 31 December*
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 ÷ 1.09139 + CU5,400 ÷ $(1.09139)^2$ = CU4,900. The effective interest rate can be determined using the 'Goal Seek' function in an Excel spreadsheet.

Ex 77 The facts are the same as in Example 75. However, in this example, the SME's functional currency is FCU.[4] 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:

<u>**Initial recognition**</u>

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.

<u>**20X1**</u>

<u>**Interest**</u>

Dr	Profit or loss—interest expense	FCU72.3[(b)]	
	Cr Loan (financial liability)		FCU72.3

To recognise interest expense for the period.

<u>**Cash**</u>

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 measured at FCU980.39 (that is, CU5,000 ÷ 5.1).

An exchange gain of FCU13.91 arises from the difference between the FCU980.39 recorded at 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 – FCU78.43).

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

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 – 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 – FCU1,069.28 = FCU280.72

Ex 78 On 1 January 20X0 a bank provides an SME with a five-year loan for CU5,000. The bank charges the SME 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 SME an additional amount (an upfront fee) of CU400 which is considered to compensate the SME for paying the higher rate of interest. The SME 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 58).

The journal entries at the end of 20X0 are as follows:

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 measured at CU5,331.81.

The effective interest rate is 8% rounded (that is, the market rate).

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)	–

(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.

Ex 79 **On 1 January 20X4 SME 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 20X8. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6% in 20X4 (CU75), 8% in 20X5 (CU100), 10% in 20X6 (CU125), 12% in 20X7 (CU150), and 16.4% in 20X8 (CU205). The SME 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 59).

The journal entries at the end of 20X4 are as follows:

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 20X4, the loan is measured at CU1,300.16.

The effective rate is 10.013%.

The amortised cost in each period is as follows:

Time	*Carrying amount at 1 January*	*Interest at 10.013%*[(a)]	*Cash outflow*	*Carrying amount at 31 December*
20X4	1,250.00	125.16	(75)	1,300.16
20X5	1,300.16	130.19	(100)	1,330.35
20X6	1,330.35	133.21	(125)	1,338.56
20X7	1,338.56	134.03	(150)	1,322.59
20X8	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.

Ex 80 **On 1 April 20X5 a bank provides an SME 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 SONIA plus 2.5%, with interest payable annually in arrears. On 1 April 20X5 SONIA is 2% and on 31 December 20X5 SONIA is 2.5%.**

Because the interest is payable at the market rate for that type of loan, the loan is measured by the SME 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.

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 SONIA varies. However, because interest is charged at the market rate for this type of loan, if the effective interest rate is set to SONIA 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 81 **The facts are the same as in Example 80. However, in this example, the SME 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 (because 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:

	Carrying amount at start of period	*Transaction fees taken to profit or loss at 0.252%*[(a)]	*Carrying amount at end of period*
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.

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.

Example—changes in estimated cash flows

Ex 82 On 1 January 20X5 a bank provides an SME 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 20X5 the SME decides that it would like to repay half the loan on 31 December 20X6 and half on 31 December 20X7, instead of the full amount on 31 December 20X8. This will reduce the interest payments by CU200 in 20X3 and mean no interest is payable in 20X8. The contract allows for early prepayment at the option of the SME and so this is not a change in the terms of the loan.

Because the interest is at market rate, on 1 January 20X5 the SME will have initially measured the loan at the transaction price, minus transaction costs (CU4,900).

The following was the original amortised cost calculation at 1 January 20X5:

Time	*Carrying amount at 1 January*	*Interest at 8.612%*[(a)]	*Cash outflow*	*Carrying amount at 31 December*
20X5	4,900.00	421.99	(400.00)	4,921.99
20X6	4,921.99	423.89	(400.00)	4,945.88
20X7	4,945.88	425.94	(400.00)	4,971.82
20X8	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 20X5 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 20X5 the amortised cost was CU4,921.99. The difference of CU36.86 (CU4,958.85 – CU4,921.99) is recognised in profit or loss during 20X5.

Therefore, further journal entries to recognise this difference on 31 December 20X5 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.

Note: The interest expense and cash payment will be recognised in 20X5 as well because they are unaffected by the revised payments. The journal entries are as follows:

Interest incurred

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

To recognise interest expense for the period.

Cash payment

Dr Loan (financial liability)	CU400	
Cr Cash		CU400

To recognise the settlement of a financial liability.

The discounted present value calculation at 31 December 20X5 is as follows:

Time	*Cash outflow*	*Present value at 31 December 20X5 discounted at 8.612%*
31 December 20X6	2,900 (400 + 2,500)	$2{,}900 \div 1.08612 = 2{,}670.05$
31 December 20X7	2,700 (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 20X6 is as follows:

Time	*Carrying amount at 1 January*	*Interest at 8.612% (effective interest rate)*	*Cash outflow*	*Carrying amount at 31 December*
20X6	4,958.85	427.06	(2,900.00)	2,485.91
20X7	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.

Educational 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 increase or decrease 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.

Educational 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.

Entities sometimes use terms such as provision for bad debts, write-off or write-down and impairment charge to describe an impairment loss. In this module, the term 'impairment loss' is used.

Example—impairment recognition

Ex 83 **SME A lends CU100 to an employee for one year with interest payable at 8%. SME A 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). SME A wishes to recognise an impairment loss of CU10 on the loan because in the past, SME A has found that, on average, 10% of its trade receivable balances (that is, amounts due from customers) are not repaid.**

SME A cannot recognise an impairment loss of CU10 based on its impairment rate for its customers. 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).

An impairment loss would be recognised only if there is objective evidence of impairment of the employee loan. 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 debtor or issuer operates.

Educational 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.

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.

Educational notes

The only instruments within the scope of Part I 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, these instruments must be individually assessed for impairment.

For the purposes of a collective assessment 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 assessed 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.

Part I of Section 11 does not permit an entity to recognise impairment 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.

Examples—unit of account for impairment testing

Ex 84 **An SME sells goods on credit to its customers. At its year-end the SME 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 SME wishes to recognise an allowance for impairment loss against trade receivables of 2% of CU10,000 (the carrying amount of trade receivables in the SME's statement of financial position would be CU9,800).**

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

The method of recognising impairment losses by the SME 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 and have occurred at year-end. 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 collectively material, 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 was 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 SME should recognise an impairment loss against the CU500 owed by the customer who has gone into liquidation. The impairment loss is based on how much of the CU500 the SME expects will not be recovered from the customer. The SME may be able to recognise further impairment losses 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 85 **An SME calculates impairment of a trade receivable on the basis of a formula that specifies fixed rates for an allowance for impairment losses based on 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 recognising impairment losses by the SME 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 collectively material, those specific balances must be assessed individually rather than applying the formula to them.

In the circumstances that the formula was appropriate, it must be reviewed for reasonableness on a regular basis. In particular, if the SME'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.

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 11.14(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.

Educational notes

The carrying amount of the asset is reduced, either directly or through use of an allowance account (for example, 'an allowance for impairment loss (provision)' is sometimes used for trade receivables—see Example 86). 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.

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 minus 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. The entity must try to make an estimate of the impairment even if it is only an approximation. Such an approximation is better than simply ignoring the impairment.
- Entities can look to Section 12 *Fair Value Measurement* for valuation techniques that can be applied to calculate the best estimate it would receive for the asset if the asset were to be sold at the reporting date.

Examples—impairment loss measurement

Ex 86 At the end of a financial reporting period an SME has an outstanding trade receivable of CU1,000. This balance was not discounted because the transaction took place on normal business terms (short-term credit) and it was not a financing transaction. Because of financial difficulties being experienced by the customer, the SME does not expect the customer to repay any of the CU1,000.

The SME must recognise an impairment loss for the full balance outstanding. The carrying amount of the trade receivable may 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.

Alternatively, the carrying amount may be reduced through use of an ‘allowance account’ (for example, an ‘allowance for impairment loss’), as follows:

Dr Profit or loss—impairment loss	CU1,000	
Cr Allowance for impairment loss (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 allowance for impairment loss in the SME’s statement of financial position.

Ex 87 The facts are the same as in Example 86. However, in this example, the SME has given the customer extra time to repay the debt. The SME expects the customer will be able to pay approximately 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 because the transaction is no longer on normal business terms and effectively constitutes a financing transaction (a one-year interest-free loan).

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

The receivable is recognised at CU952.38 (that is, CU1,000 ÷ 1.05).

The carrying amount of the trade receivable may 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.

Alternatively, the carrying amount may be reduced through use of an 'allowance account' (for example, an 'allowance for impairment loss'), as follows:

Dr	Profit or loss—impairment loss	CU47.62	
Cr	Allowance for impairment loss (set off against the financial asset)		CU47.62

To recognise the impairment loss.

Ex 88 An SME is concerned that one of its employees (Employee B) will not be able to make all principal and interest payments due on a loan in a timely manner because the employee is experiencing financial difficulties. The SME and the employee negotiate a restructuring of the loan. The SME expects that the employee will be able to meet its obligations under the restructured terms. In which of the following cases (different restructuring scenarios) would the SME need to recognise an impairment loss?

(a) Employee 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) Employee 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) Employee 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) Employee 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) Employee 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) because 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 Employee B's financial difficulties, case (e) would need to be carefully considered to ensure it is a realistic restructuring scenario.

Ex 89 **On 1 January 20X4 an SME 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 SME has a 31 December financial year-end.**

On 31 December 20X5, because of financial difficulties, the employee asked to extend the interest-free loan for a further three years. The SME agreed. Under the restructured terms, repayment will take place on 31 December 20X9. However, the SME 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 49).

The amortised cost calculation at 1 January 20X4 is as follows:

Time	*Carrying amount at 1 January*	*Interest at 5%*	*Cash inflow*	*Carrying amount at 31 December*
20X4	431.92	21.59	–	453.51
20X5	453.51	22.68	–	476.19
20X6	476.19	23.81	(500.00)	–

On 31 December 20X5 the carrying amount of the loan receivable is CU476.19.

As a result of that modification, on 31 December 20X5 the present value of estimated cash flows is recalculated to be CU205.68 using the asset's original effective interest rate of 5% (CU250 ÷ $(1.05)^4$).

An impairment loss of CU270.51 (CU476.19 – CU205.68) is recognised in profit or loss in 20X5.

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 20X5.

Alternatively, it can be reduced through use of an 'allowance account' (for example, an 'allowance for impairment loss'), as follows:

Dr Profit or loss—impairment loss	CU270.51	
Cr Allowance for impairment loss (set off against the financial asset)		CU270.51

To recognise the impairment loss.

The revised amortised cost calculation at 1 January 20X6 is as follows:

Time	*Carrying amount at 1 January*	*Interest at 5% (the original effective interest rate)*	*Cash inflow*	*Carrying amount at 31 December*
20X6	205.68	10.28	–	215.96
20X7	215.96	10.80	–	226.76
20X8	226.76	11.34	–	238.10
20X9	238.10	11.90	(250.00)	–

Ex 90 **On 1 January 20X4 an SME 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 SME has a 31 December year-end.**

On 31 December 20X4 the employee told the SME that he was experiencing financial difficulties. The SME 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 20X4 and 20X5 (that is, the interest is waived). However, interest payments in 20X6 and 20X7 are expected to be paid and the principal should be repaid as expected on 31 December 20X7.

On initial recognition, because the interest was at the market rate, the SME initially measured the loan receivable at the transaction price (that is, CU5,000).

The amortised cost calculation at 1 January 20X4 is as follows:

Time	*Carrying amount at 1 January*	*Interest at 8%*	*Cash inflow*	*Carrying amount at 31 December*
20X4	5,000	400	(400)	5,000
20X5	5,000	400	(400)	5,000
20X6	5,000	400	(400)	5,000
20X7	5,000	400	(5,400)	–

On 31 December 20X4 the carrying amount of the loan receivable is CU5,400 (CU5,000 in the preceding table plus the CU400 of interest not paid in 20X4 as expected).

As a result of the restructuring, on 31 December 20X4 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 – CU4,629.63) is recognised in profit or loss for 20X5.

The SME 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 20X5.

The revised amortised cost calculation at 1 January 20X5 is as follows:

Time	*Carrying amount at 1 January*	*Interest at 8%*	*Cash inflow*	*Carrying amount at 31 December*
20X5	4,629.63	370.37	–	5,000.00
20X6	5,000.00	400.00	(400.00)	5,000.00
20X7	5,000.00	400.00	(5,400.00)	–

The discounted present value calculation at 31 December 20X4 is as follows:

Time	*Cash payment*	*Present value discounted at 8%*
31 December 20X6	400.00	$400 \div 1.08^2 = 342.94$
31 December 20X7	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.

Examples—reversal of a prior period impairment loss

Ex 91 The facts are the same as in Example 86. However, in this example, after the prior-year financial statements were authorised for issue the SME received CU200 from the customer. The SME does not expect to receive the remaining CU800.

In the current reporting period, the SME 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 86, the SME 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, an 'allowance for impairment loss') the SME 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 Allowance for impairment loss (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 Allowance for impairment loss (set off against the financial asset)	CU200	
Cr Trade receivable (financial asset)		CU200

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

Ex 92 The facts are the same as in Example 89. However, in this example, on 14 December 20X7 the employee won the lottery and told the SME he will repay the loan in full in January 20X8 (two years ahead of the date agreed in the restructuring).

Without the decision to repay, on 31 December 20X7 the carrying amount of the loan receivable would have been CU453.51 (see the first table in Example 89).

Because 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 is recognised in profit or loss for the year ended 31 December 20X7 of CU46.49 (that is, CU500 – 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.

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

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.

Educational 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 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 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 Accounting Standards for guidance. IFRS 9 *Financial Instruments* paragraph 3.2.7 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 assessing whether the entity has transferred substantially all of the risks and rewards of ownership.

If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity continues to recognise the financial asset. If an entity retains only some of the significant 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).

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 regarding 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.
- 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 limits 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 minus any new liability assumed) is recognised in profit or loss.

Examples—derecognition of financial assets

Ex 93 The following are four examples of when an SME 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 SME (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 SME will need to repurchase the shares). Therefore, this is effectively an unconditional sale.

Ex 94 The following are five examples of when an SME 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 SME 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 SME 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 SME sells its investment in unquoted shares to a bank for CU1,000. One year later the SME 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.

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.

Educational 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.

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

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

In this case, the SME 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 SME derecognises the receivables of CU19,000 from its statement of financial position, and it shows no liability in respect of the proceeds received from the third party.

The SME 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 SME 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 SME may pass the cash to the third party immediately, or it may wait and remit all amounts collected at specific periods of time or in full on a specific date. If, for example, the SME waited until all CU17,000 was received it would have a financial liability for CU17,000. In this case, on payment to the third party, the following journal entry is 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 SME will pass all receipts to the third party up to a maximum amount of CU19,000. Also, if receipts are less than CU19,000 the SME will be liable for the difference (that is, in all cases the third party will receive CU19,000).**

CU17,000 of the trade receivables are settled by the SME's customers. The SME pays a further CU2,000 on to the third party.

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

Accordingly, the SME does not recognise the receivables as having been sold to the third party. The SME continues to recognise the trade receivables as an asset until they are collected or derecognised as uncollectible.

The substance of the transaction with the third party is a secured loan—the loan is secured by the trade receivables. The SME receives a loan of CU18,000 and repays CU19,000, the difference of CU1,000 is a finance cost (interest) of the SME, 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 SME will pass all receipts to the third party up to a maximum of CU19,500. If receipts are less than CU17,200 the SME will make up the difference. Under the contract, the third party is prohibited from selling the receivables to another party.

CU17,000 of the trade receivables are actually settled. The SME pays a further CU200 on to the third party.

In this case, the SME has retained some of the risks and rewards of ownership of the receivables. The SME and the third party share the credit risk. Also, the SME and the third party can both benefit from the upside.

Because the third party is prohibited from selling the receivables, the third party does not have the practical ability to sell the asset. Therefore, the SME does not treat the receivables as having been sold to the third party, and it does not derecognise them. The SME continues to recognise the receivables as an asset until they are collected or impaired as uncollectible.

The SME recognises a financial liability for the consideration received of CU18,000.

Ex 99 The facts are the same as in Example 96. However, in this example, the SME will pass all receipts to the third party up to a maximum of CU19,500. If receipts are less than CU17,200 the SME 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.

CU17,000 of the trade receivables are actually settled. The SME pays a further CU200 on to the third party.

In this case, the SME has retained some of the risks and rewards of ownership of the receivables. The SME and the third party both share credit risk. Both can also benefit from the upside (see Example 97).

Because the third party can sell the receivables freely, the third party would be considered to have control. Therefore, the SME 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 does not meet the principle in paragraph 11.9ZA and therefore it is outside the scope of Part I of Section 11. This financial instrument is accounted for in accordance with Part II of Section 11 and will not be discussed further here. However, it is discussed later in this module under Part II of Section 11.

Derecognition of a financial liability

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.

Educational 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.

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 Part II of Section 11); 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.

Educational 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 Standard does not provide guidance on how to make this judgement. In these circumstances the entity may (but is not required to) refer to full IFRS Accounting Standards for guidance (see paragraph 10.6 of the Standard). Paragraph B3.3.6 of IFRS 9 provides guidance on how to make this judgement, stating that 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.

Paragraph B3.3.6A of IFRS 9 explains that 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 of the Standard). Any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

Examples—derecognition of financial liabilities

Ex 100 On 1 January 20X1 a bank provides an SME with a four-year loan of CU5,000 on normal market terms, including 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 SME 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 SME paid the bank a fee of CU50 for paperwork relating to the modification.

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

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

Time	*Carrying amount at 1 January*	*Interest at 8.612%*[(a)]	*Cash outflow*	*Carrying amount at 31 December*
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). 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 SME applies its judgement to decide whether the terms of the instruments exchanged are substantially different. If the SME decides to look to full IFRS Accounting 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 SME concluded that this modification should not be considered a substantial modification of the terms of the existing loan. Therefore, 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:

Time	*Cash outflow*	*Present value at 31 December 20X1 discounted at 8.612%*
31 December 20X2	250.00	250 ÷ 1.08612 = 230.18
31 December 20X3	250.00	250 ÷ 1.08612^2 = 211.93
31 December 20X4	5,250.00	5,250 ÷ 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 SME is not required to pay any interest under the revised terms of the loan. The SME 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 ÷ $(1.08612)^4$). 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 ÷ CU4,921.99) of the present value of the remaining cash flows of the original financial liability.

The SME applies its judgement to decide whether the terms of the instruments exchanged are substantially different. If the SME decides to look to full IFRS Accounting 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 SME 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 – CU3,675.15 – 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.

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 SME 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:

Time	*Carrying amount at 1 January*	*Interest at 8%*	*Cash outflow*	*Carrying amount at 31 December*
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 Part II of Section 11) 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 **material** accounting policy information. Information about the **measurement basis** (or bases) for financial instruments in preparing the financial statements is expected to be material accounting policy information.

Example—disclosure of accounting policies for financial instruments

Ex 102 Extract from notes to SME A's financial statements for the year ended 31 December 20X5

Note 2 Accounting policies

Investments in non-puttable ordinary shares

Investments in non-puttable ordinary shares in entities that are not associates, joint arrangements 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.

Loan receivables

Loans are occasionally provided to associates or employees. Loan receivables are measured at amortised cost using the effective interest method less any impairment. Interest income is included in other income.

Trade receivables

Most sales are made on normal short-term credit terms (30 days from the date of invoice) and the trade receivables do not bear interest. Trade receivables are measured at cost, except when credit is extended to customers that are not expected to pay within one year from the date of delivery. In such instances, the receivables are measured at amortised cost. At the end of each reporting period, the entity assesses whether there is objective evidence of impairment of the trade receivables. If so, an impairment loss is recognised immediately in profit or loss.

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 the financial asset 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. 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 paragraph 11.54);

(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 paragraph 11.54);

(d) financial liabilities measured at fair value through profit or loss (paragraph 11.54);

(e) financial liabilities measured at amortised cost (paragraph 11.14(a)); and

(f) loan commitments measured at cost less impairment (paragraph 11.14(b)).

Educational notes

An entity may wish to present the disclosures required by paragraph 11.41 in a separate table (see Example 106), 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 SME A's financial statements for the year ended 31 December 20X5

Note 14 Carrying amounts of financial assets and financial liabilities

	Fair value through profit or loss		*Amortised cost*		*Total*	
	20X5 CU	*20X4 CU*	*20X5 CU*	*20X4 CU*	*20X5 CU*	*20X4 CU*
Financial assets						
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
Financial liabilities						
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

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 SME A's financial statements for the year ended 31 December 20X5

Note 25 Bank overdrafts and loans

	20X5 ***CU***	***20X4*** ***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 SONIA 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 20X9. 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 20X5 (CU312,000 at 31 December 20X4) (see note 12).

Interest is payable on the variable-rate loan at SONIA plus 1%. The variable-rate bank loan is fully repayable on 16 January 20X6. Early payment is prohibited. The variable-rate loan is secured by CU300,000 of trade receivables (see note 16).

11.43 An entity shall disclose an analysis of the age, by reference to due date, of trade receivables and other financial assets measured at amortised cost at the reporting date, showing separately:

(a) the amortised cost of the financial assets before adjusting for any reduction (directly or by using an allowance account) for impairment or uncollectability (see paragraph 11.15(d)); and

(b) any reduction (directly or by using an allowance account) for impairment or uncollectability (see paragraph 11.15(d)).

Educational notes

The analysis of the age of trade receivables and other financial assets reflects amounts outstanding from customers/parties and the age of the trade receivable and/or the financial assets. The age is determined with reference to the due date.

Paragraph 11.43 requires entities to show separately:

(a) the amortised cost of the financial asset before adjusting for any reduction for impairment or uncollectability; and

(b) any reduction for impairment or uncollectability.

The amount in paragraph 11.43(b) is the accumulated impairment loss recognised in the current period and in any previous periods (that is, the balance of the impairment loss). For example, if an entity recognised an impairment loss of CU1,500 on a trade receivable in a previous period and in the current period recognised an impairment loss of CU2,000, the amount to be shown applying paragraph 11.43(b) is the total of CU3,500.

The total of the amounts in the age analysis should reconcile to the amount that is presented in the statement of financial position. Paragraph 11.43B provides examples of time bands that might be used in preparing the age analysis. However, an entity can decide to use different time bands, if it concludes that they are more useful.

Example—disclosure of the analysis of the age of trade receivables and maturity analysis of financial liabilities

Ex 105 Extract from notes to SME A's financial statements for the year ended 31 December 20X5

Note 15 Analysis of age of trade receivables

The table analyses the age of the Entity's trade receivables by reference to their due date.

	Not yet due	Less than 1 month	1–3 months	3 months –1 year	1–5 years	More than 5 years	Total
	CU	CU	CU	CU	CU	CU	CU
20X5							
Amortised cost before impairment	190,000	130,000	245,000	115,000	85,000	15,000	780,000
Impairment	–	(10,000)	(68,000)	(80,000)	(78,654)	(14,558)	(251,212)
	190,000	120,000	177,000	35,000	6,346	442	528,788
20X4							
Amortised cost before impairment	175,000	160,000	251,000	116,500	91,000	21,000	814,500
Impairment	–	(13,212)	(72,100)	(90,000)	(90,014)	(20,790)	(286,116)
	175,000	146,788	178,900	26,500	986	210	528,384

11.43A An entity shall disclose a maturity analysis for financial liabilities by category (see paragraphs 11.41(d)–(e)). The maturity analysis shall include the remaining contractual maturities. The contractual amounts disclosed in the maturity analysis are the contractual undiscounted cash flows.

11.43B In preparing the disclosures in paragraphs 11.43–11.43A, an entity shall use time bands it considers to be the most useful. For example, for paragraph 11.43 the time bands might be:

(a) not later than one month;

(b) later than one month and not later than three months;

(c) later than three months and not later than one year;

(d) later than one year and not later than five years; and

(e) later than five years.

Educational notes

Paragraph 11.43A requires an entity to disclose a maturity analysis that shows the remaining contractual maturities for financial liabilities. In this disclosure:

(a) when a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (for example, a puttable bond) are included in the earliest time band.

(b) when an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.

(c) for issued financial guarantee contracts the maximum amount of the guarantee is allocated to the earliest period in which the guarantee could be called.

The contractual amounts disclosed in the maturity analysis are the contractual cash flows, for example gross loan commitments, gross lease liabilities and prices specified in forward agreements to purchase financial assets for cash.

Such undiscounted cash flows differ from the amount included in the statement of financial position because the amounts in that statement are measured in accordance with Section 11, and in some instances would be discounted. When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the end of the reporting period. For example, when the amount payable varies with changes in variable rate, the amount disclosed may be based on the level of the variable rate at the end of the period.

Extract from notes to SME A's financial statements for the year ended 31 December 20X5

Note 20 Maturity analysis of financial liabilities

The table analyses the Entity's financial liabilities based on their remaining contractual maturities. The amounts are the contractual undiscounted cash flows, including interest payments.

	Total	Less than 1 month	1–3 months	3 months –1 year	1–5 years
	CU	CU	CU	CU	CU
20X5					
Bank overdraft	83,600	83,600	–	–	–
Trade payables	454,858	174,858	250,000	30,000	–
Interest payable	2,000	1,200	800	–	–
Bank loan	55,000	–	625	1,875	52,500
20X4					
Bank overdraft	115,507	115,507	–	–	–
Trade payables	420,520	170,520	200,000	50,000	–
Interest payable	1,200	–	1,200	–	–
Bank loan	172,500	–	1,875	5,625	165,000

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 instrument 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.

Transferred financial assets that do not qualify for 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 SME A's financial statements for the year ended 31 December 20X5

Note 16 Trade and other receivables

	20X5 CU	*20X4 CU*
Trade receivables	585,548	487,678
Prepayments	1,700	1,610
Total	587,248	489,288

During 20X5 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 20X5 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.

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 SME A's financial statements for the year ended 31 December 20X5

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 entity with a carrying amount of CU266,000 at 31 December 20X5 (CU312,000 at 31 December 20X4). 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 SME A's financial statements for the year ended 31 December 20X5

Note 25 Bank overdrafts and loans

At 31 December 20X5 the entity 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 20X6. 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.

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 SME A's financial statements for the year ended 31 December 20X5:

Note 8 Other income (extract)

	20X5	***20X4***
	CU	***CU***
Dividends	460	430
Interest income	300	290

Note 9 Finance costs (extract)

	20X5	***20X4***
	CU	***CU***
Interest on bank overdraft and loans	13,450	9,110

Note 10 Profit for the year (extract)

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

Part II of Section 11
Other Financial Instrument Issues

Scope of Part II of Section 11

11.49 Part II of Section 11 applies to all financial instruments except the following:

(a) those covered by Part I of Section 11.

(b) investments in **subsidiaries** and **associates** and **joint arrangements** that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Joint Arrangements*.

(c) employers' rights and obligations under **employee benefit** plans (see Section 28 *Employee Benefits*).

(d) rights under **insurance contracts** unless the insurance contract could result in a loss to either party as a result of contractual terms that are unrelated to:

(i) changes in the insured risk;

(ii) changes in foreign exchange rates; or

(iii) a default by one of the counterparties.

(e) 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*).

(f) **leases** within the scope of Section 20 *Leases*. Consequently, Part II of Section 11 applies to leases that could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to:

(i) changes in the price of the leased **asset**;

(ii) changes in foreign exchange rates;

(iii) changes in lease payments based on variable market interest rates; or

(iv) a default by one of the counterparties.

(g) the measurement requirements do not apply to contracts for contingent consideration in a **business combination** (see Section 19 *Business Combinations and Goodwill*) whose fair value cannot be measured reliably without undue cost or effort at the acquisition date (see paragraph 19.27).

(h) financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 *Share-based Payment* applies.

(i) reimbursement assets that are accounted for in accordance with Section 21 *Provisions and Contingencies* (see paragraph 21.9).

(j) rights and obligations within the scope of Section 23 *Revenue from Contracts with Customers* that are financial instruments, except for trade receivables that are not accounted for in accordance with Part I of Section 11.

(k) **financial guarantee contracts** issued at nil consideration when the specified debtor is another entity within the **group** (see paragraph 21.1A). Part II of Section 11 applies to other issued financial guarantee contracts.

11.50 Most contracts to buy or sell a non-financial item such as a commodity, **inventory** or **property, plant and equipment** are excluded from this section because they are not financial instruments. However, Part II of Section 11 applies to all contracts that impose risks on the buyer or seller that are not typical of contracts to buy or sell non-financial items. For example, Part II of Section 11 applies to contracts that could result in a loss to the buyer or seller as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates or a default by one of the counterparties.

11.51 In addition to the contracts described in paragraph 11.50, Part II of Section 11 applies to contracts to buy or sell non-financial items if the contract can be settled net in **cash** or another financial instrument, or by exchanging financial instruments as if the contracts were financial instruments, with the following exception: contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are not financial instruments for the purposes of Section 11.

Educational notes

Part II of Section 11 applies to:

- all financial instruments (as defined in the Glossary) except those within the scope of Part I of Section 11 and those specifically excluded from the scope of Part II of Section 11 by paragraphs 11.49(b)–(k); and
- some contracts to buy or sell non-financial items (see paragraphs 11.50–11.51).

Financial instruments are within the scope of Part I of Section 11 if they meet the criteria in paragraph 11.8 and are not excluded from the scope of Part I of Section 11 by paragraph 11.7. Instruments that are within the scope of Part I of Section 11 applying paragraph 11.8 are:

- cash;
- debt instruments (for example, accounts, notes, or loans receivable or payable) meeting specified conditions;
- commitments to receive a loan that cannot be settled net in cash and where the loan is expected to meet the same conditions as for the aforementioned debt instruments; and
- investments in non convertible preference shares and non-puttable ordinary shares or preference shares.

For additional guidance on the identification of financial instruments within the scope of Part I of Section 11, consult earlier sections of this module on Part I of Section 11. If an entity has any other financial instrument, it must consider Part II of Section 11.

Even entities that normally only have simple transactions may occasionally enter into transactions within the scope of Part II of Section 11. For example, a fixed-term loan with interest payable at SONIA plus 2% is accounted for applying Part I of Section 11, because the variable rate is a single referenced quoted or observable interest rate; however, if the interest was payable at a rate equal to the change in the published price of gold, the instrument would be outside the scope of Part I of Section 11 and within the scope of Part II of Section 11.

Some financial instruments that are outside the scope of Part I of Section 11 nevertheless do not need to be accounted for applying Part II of Section 11 because they are excluded by paragraph 11.49.

If there are no financial instruments and no contracts that are required to be accounted for in accordance with Part II of Section 11, then the entity does not need to apply Part II of Section 11. However, the entity should continue to evaluate any new or substantially modified financial instruments or related transactions to identify whether it needs to apply Part II of Section 11.

See examples in earlier sections of Module 11 for the following:

- Examples 5–14 of this module are examples of items that are not financial instruments and, therefore, are not within the scope of Part I of Section 11 nor Part II of Section 11.
- Examples 40–41 and Examples 17–19 are examples of common financial instruments and they illustrate how to identify financial instruments. The financial instruments in Examples 15 and 17–19 are within the scope of Part I of Section 11.
- Examples 21–29 illustrate how to identify financial instruments that are within the scope of Part I of Section 11. The financial instruments in these examples are within the scope of Part I of Section 11.

Paragraphs 11.6 and 11.11 of the Standard list the following examples of financial instruments that are normally within the scope of Part II of Section 11 (although exceptions exist; see, for example, paragraph 11.49):

- asset-backed securities, such as collateralised mortgage obligations (bonds that represent claims to specific cash flows from large pools of mortgages), repurchase agreements (a type of short-term loan whereby the seller of a security agrees to buy it back at a specified price and time) and securitised packages of receivables (instruments such as bonds in a special purpose vehicle that holds receivables).
- options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument.
- financial instruments that qualify and are designated as hedging instruments applying the requirements in Part II of Section 11, for example, a foreign currency forward exchange contract.
- commitments to make a loan to another entity. A commitment to make a loan is a firm commitment to provide credit under pre-specified terms and conditions; for example, a commitment to provide, in six months, a three-year loan of CU100,000 with interest fixed at 4% a year.
- commitments to receive a loan if the commitment can be net settled in cash.
- contingent consideration recognised by an acquirer in a business combination.
- issued financial guarantee contracts—however, financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group are in the scope of Section 21 (see paragraph 21.1A).
- an investment in another entity's equity instruments, other than non-convertible preference shares and non-puttable ordinary and preference shares. A puttable instrument gives the holder the right to put the instrument back to the issuer for cash or another financial asset or the instrument is automatically put back to the issuer on the occurrence of particular events.
- 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.
- investments in convertible debt.

Educational notes—scope of Part II of Section 11

The following flow chart can be used to identify if a financial instrument is within the scope of Part II of Section 11.

Does the contract meet the definition of a financial asset, financial liability or equity as defined in the Glossary?

No → Determine whether another section of the Standard is applicable or apply paragraphs 10.4–10.6 to develop an accounting policy.

Yes ↓

Is the contract within the scope of another section of the Standard and therefore outside the scope of Section 11 (see paragraph 11.7)?

Yes → Apply the relevant section of the Standard as required in paragraph 11.7

No ↓

Is the contract within the scope of Part I of Section 11 (see paragraph 11.8)?

Yes → Apply Part I of Section 11

No ↓

Is the contract outside the scope of Part II of Section 11 (see paragraph 11.49(d), (f) and (g))?

Yes →

- If paragraph 11.49(d) applies, then apply Section 2
- If paragraph 11.49(f) applies, then apply Section 20
- If paragraph 11.49(g) applies, then apply Section 19

No ↓

Apply Part II of Section 11

A number of financial instruments that would otherwise be within the scope of Part I and Part II of Section 11 are excluded from the scope of this section and instead fall within other sections of the Standard. For example, interests in a subsidiary are accounted for applying Section 9. Thus, a holding of convertible preference shares in a third party company will be within the scope of Part II of Section 11, but such a holding in a subsidiary is accounted for applying Section 9.

For some types of contracts, the determining factor of whether the contract is within or outside the scope of Part II of Section 11 is whether the contract exposes the parties to the contract to one or more risks not usually expected in an equivalent 'plain vanilla' contract. Specifically, an insurance contract, a lease or a contract to buy or sell a non-financial item is within the scope of Part II of Section 11 if the contract terms expose the parties to risk of a possible loss as a result of something other than:

- one of the parties to the contract defaulting;
- changes in foreign exchange rates; or
- changes in the pricing of whatever the contract is for, for example, changes in the price of gold if it is a forward contract to buy gold, changes in the price of a particular machine if it is a lease of the machine, or an increase in the insurance premiums due to a change in the insured risk such as an increase in the insurance premiums for a factory that recently flooded during bad weather if it is buildings insurance of the factory.

Insurance contracts, lease contracts or contracts to buy or sell a non-financial item that expose the parties to risk of loss for these three things are outside the scope of Part II of Section 11, but contracts that expose the parties to risk of other losses are accounted for, applying Part II of Section 11, as financial instruments.

Paragraph 11.49(d)—rights under insurance contracts

Under insurance contracts most rights of policyholders, beneficiaries or any insurers within the scope of the Standard are outside the scope of Part II of Section 11 and hence are accounted for under other sections. For example, for policyholders, any contingent assets would be within the scope of Section 21.

However, paragraph 11.49(d) requires that any rights under insurance contracts be accounted for applying Part II of Section 11 if they might result in a loss to the policyholder or the insurer as a result of contractual terms that are unrelated to changes in the insured risk, changes in foreign exchange rates or a counterparty's default. For example, a life insurance contract with a maturity payout linked to the price of a specific commodity, such as gold, will be accounted for applying Part II of Section 11. This is because the terms of the financial instrument include a financial risk component that alters the settlement amount of the contract in a way that is unrelated to the insuring of the insured item.

Paragraph 11.49(e)—entity's own equity

The exemption in paragraph 11.49(e) applies only to the issuer of the equity instrument and not to the holder. Section 22 specifies how an issuer classifies financial instruments as either financial liabilities or equity. Consequently, before applying Section 11, the entity must decide, applying Section 22, whether a financial instrument is a financial liability, equity or an instrument that contains both equity and liability components. Section 11 applies to instruments that are financial liabilities, and to the liability component of a financial instrument with both equity and liability components. Section 11 does not apply to financial instruments or components of financial instruments that are that entity's own equity instruments.

Share-based payment transactions accounted for as equity applying Section 26 are outside the scope of Section 11.

Paragraph 11.49(f)—leases

Most leases result in financial instruments—the lessor has a contractual right to receive cash (future lease payments) and the lessee has a contractual obligation to pay cash (future lease payments). Leases are generally excluded from the scope of Part II of Section 11 because Section 20 sets out the requirements for their accounting. However, applying paragraph 11.49(f), a lease that could result in a loss to the lessee or the lessor as a result of contractual terms unrelated to changes in the price of the leased asset, changes in foreign exchange rates, changes in lease payments based on variable market interest rates or a default by one of the counterparties, is to be accounted for applying Part II of Section 11 and is excluded from the scope of Section 20 (see also paragraph 20.1(e)). Such leases are within the scope of Part II of Section 11 because their terms include a component that alters the settlement amount of the contract that is unrelated to the leasing of the asset.

Judgement needs to be applied in interpreting 'unrelated' as used in paragraphs 11.49(d), 11.49(f) and 11.50.

An example of a lease that would fall within the scope of Part II of Section 11 would be a lease for a retail unit in a large shopping mall for which the payments are a fixed annual amount plus a contingent annual rental of 1% of the profit after tax made by the lessee on its business from that retail unit. However, an example of a lease that would be outside the scope of Part II of Section 11 (and within the scope of Section 20) would be a lease for a retail unit in a large shopping mall for which the payments are increased each year by a percentage equal to the percentage change in the fair value of the shopping mall. The change in payment would be related to the change in the price of the leased asset; so the lease would not be within the scope of Part II of Section 11.

Below are more details about some financial instruments that are outside the scope of Part II of Section 11 in accordance with paragraph 11.49.

A provision for an onerous operating lease contract, for example, a lessee's provision made for vacant leasehold property that it has been unable to sublet, is accounted for applying Section 21 (see paragraph 21.1(a)) unless it meets the exception in paragraph 11.49(f).

Paragraph 11.49(g)—contingent consideration

The measurement requirements in Part II of Section 11 apply to contingent consideration in a business combination, whose fair value can be measured reliably without undue cost or effort. If the fair value of the contingent consideration in a business combination cannot be measured reliably without undue cost or effort, the contingent consideration is out of the scope of Part II of Section 11 and is measured in accordance with Section 19.

Paragraph 11.49(j)—rights and obligations that are financial instruments that are within scope of Section 23, except for trade receivables that are not accounted for in accordance with Part I of Section 11

Rights and obligations within the scope of Section 23 that are financial instruments, for example, some refund liabilities, are outside the scope of Part II of Section 11. However, trade receivables that are not accounted for in accordance with Part I of Section 11 are accounted for in accordance with Part II of Section 11.

Paragraph 11.49(k)—financial guarantee contracts issued at nil consideration

Issued financial guarantee contracts are listed in paragraph 11.6 as an example of financial instruments that fall within the scope of Part II of Section 11. However, financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group are outside the scope of Part II of Section 11. These financial guarantee contracts are accounted for in accordance with Section 21. For example, if an entity issued a financial guarantee contract for a fee to a bank and the specified debtor is not an entity within the group, the issued financial guarantee contract is within the scope of Part II of Section 11. However, if the specified debtor is the entity's subsidiary and there was no fee charged, then the issued financial guarantee contract is outside the scope of Part II of Section 11.

Examples—scope of Part II of Section 11—paragraph 11.49

Ex 110 On 1 January 20X4, SME A, which manufactures bicycles, took out a CU100,000 five-year variable-interest rate loan from Bank B. Interest is payable on the loan at SONIA plus 100 basis points. SONIA increased twice during 20X6. Concerned about rising expectations that interest rates are to increase again in the near future, SME A, on 1 January 20X7, takes out an interest rate swap with Bank C for the final two years of the loan; the combined effect of the swap and the loan is a loan with interest fixed at 4.5% for 20X7 and 20X8. In accordance with the swap, which assumes a principal amount of CU100,000, SME A pays 3.5% fixed interest and receives variable interest calculated at SONIA. SONIA is reset quarterly under both the loan and the swap.

The loan is within the scope of Part I of Section 11; it is a variable-rate loan meeting the conditions in paragraph 11.9. The loan will be accounted for applying Part I of Section 11 throughout the full five-year life of the loan.

The swap is within the scope of Part II of Section 11, because it is a financial instrument that is not included in paragraph 11.8 and is included in paragraph 11.11 and not exempt under paragraph 11.49.

If SME A had not taken out the swap, but had instead repaid the loan at the end of 20X6 and taken out a new two-year loan with interest fixed at 4.5%, both the original loan and the replacement loan would have been within the scope of Part I of Section 11.

The swap would be eligible for hedge accounting under Part II of Section 11 if specified criteria are met; see paragraph 11.69 and Example 139 and Example 140. The impact of hedge accounting on profit or loss in 20X7 and 20X8 would be the same as the impact of a two-year loan with interest fixed at 4.5 %, that is within the scope of Part I of Section 11.

Ex 111 SME A, a company manufacturing bicycles, contracted on 1 November 20X4 to purchase a new machine from an overseas supplier. The machine is expected to be ready for delivery on 31 January 20X5, at which time SME A is contractually required to pay the manufacturer the full price of the machine, FCU10,000. SME A was concerned about the effect of fluctuating exchange rates on its cash flows. Consequently, on 1 November 20X4 SME A also entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X5.

The forward contract to purchase FCU is within the scope of Part II of Section 11 because it is a financial instrument; it is not covered by paragraph 11.8, is included in paragraph 11.6 and it is not exempt under paragraph 11.49.

The forward contract to purchase FCU would be eligible for hedge accounting under Part II of Section 11 if specified criteria are met, see paragraph 11.61 onwards.

The contract to purchase the machine is outside the scope of Part II of Section 11—see Example 115.

Ex 112 SME A, which manufactures bicycles, purchases a subsidiary that manufactures scooters from SME B. SME A pays CU50,000 on the date of acquisition and agrees to pay a further CU50,000 to SME B two years later if the subsidiary meets specified performance targets (that is, the second CU50,000 is contingent consideration). The subsidiary expects to continually meet the performance targets during the two years.

The contingent consideration payable/receivable meets the definition of a financial liability of SME A and a financial asset of SME B. The fair value of the contingent consideration can be measured reliably without undue cost or effort at the acquisition date.

The measurement requirements of Part II of Section 11 apply to the contingent consideration payable (SME A’s financial liability) and receivable (SME B’s financial asset) because the fair value of the contingent consideration can be measured reliably without undue cost of effort. It is not excluded by paragraph 11.49(g).

Ex 113 SME A, based in Japan, is both the policyholder and the beneficiary of a life insurance contract. The 10-year contract requires the insurer to pay a sum of money upon the death or terminal illness of the owner-manager of SME A or, if earlier, at the end of the 10-year contract. Under the contract, SME A is required to pay a stipulated amount annually (premium) until the earlier of 10 years and the insured event (death or illness) occurring. If the insured event occurs, SME A (in its capacity as policyholder) will receive a fixed payment that is significantly higher than the premiums paid into the plan. If the insured event has not occurred by the end of the 10-year contract, SME A will receive a payment that equals the premiums paid into the plan, net of a pre-agreed fee, plus or minus a return equal to the percentage increase or decrease in the Nikkei 225.

The contract is outside the scope of Part I of Section 11 because the bonus is variable with the performance of the Nikkei 225, meaning that the returns to the SME are not fixed or variable based on a single referenced quoted or observable interest rate. SME A's rights under the insurance contract could result in a loss to either party, as defined in Part II of Section 11.

The variable payment is related to the movement in the Nikkei 225 and is not related to the insured risk (the owner-manager's health), to foreign exchange rates or to a counterparty's default. Consequently, SME A's rights under the insurance contract are included in the scope of Part II of Section 11 (see paragraph 11.49(d)).

Ex 114 SME A leases a machine from SME B under a five-year finance lease, which sets out fixed annual rental payments. The payments are denominated in FCU.

SME A's functional currency is the CU. SME B's functional currency is the FCU.

If the FCU strengthens against the CU, SME A, the lessee, will pay higher annual rental payments in its functional currency. However, because the loss to the lessee results from changes in exchange rates, the lease is accounted for under Section 20, because it is outside the scope of Part II of Section 11 (see paragraph 11.49(f) (ii)).

Examples—scope of Part II of Section 11—paragraph 11.50—contracts to buy or sell a non-financial item

Ex 115 On 1 January 20X4 a machine manufacturing SME, whose functional currency is the CU, enters into a contract to export an item of machinery to a buyer whose functional currency is the FCU. The contract specifies that the machine will be delivered on 1 July 20X5 and at that time the buyer will make a payment of CU10,000. The machine is intended for use in the buyer's business.

In this example, the payment in CU exposes the buyer to currency risk, because the cash flows under the contract will vary with the CU/FCU exchange rate (for example, a 'stronger' than expected CU against FCU would result in a higher purchase price for the buyer than under a similar fixed-price contract denominated in FCU using the CU:FCU spot rate on the date of contracting). Because the risk imposed relating to the change in the purchase price is due only to changes in foreign exchange rates and because the machine is intended for use in the buyer's business, this contract is outside the scope of Part II of Section 11.

Ex 116 On 1 January 20X3, SME A contracts to purchase a fixed quantity of copper rods from SME B for delivery on 30 June 20X4. The copper rods are intended for use in SME A's business. SME A and SME B operate in the same jurisdiction. The purchase price is the market price in the jurisdiction on 1 January 20X3 plus an adjustment for the jurisdiction's producer price index (PPI) between 1 January 20X3 and 30 June 20X4.

The PPI measures average changes in prices received by domestic producers for their output. It is one of several price indexes. The percentage change in the PPI is a measure of inflation in that jurisdiction.

In this example, the adjustment for inflation exposes both the buyer and seller to the risk of uncertain future cash flows. However, the price of copper rods is typically expected to be unrelated to the PPI; instead the price of the rods typically relates to the price of copper. Consequently, this contract would be within the scope of Part II of Section 11 for both the buyer and the seller.

Ex 117 On 1 January 20X3, SME A contracts to purchase a fixed quantity of copper rods from SME B for delivery on 30 June 20X4. The copper rods are intended for use in SME A's business. SME A and SME B operate in the same jurisdiction. The purchase price is the market price in the jurisdiction on 1 January 20X3 plus or minus an adjustment for the change in the price of copper between 1 January 20X3 and 30 June 20X4.

In this example, the pricing of the rods would generally be expected to vary in line with the price of copper. A potential loss to the buyer or seller could result from contractual terms that are related to the price of the non-financial item. Consequently, this contract is outside the scope of Part II of Section 11 for both the buyer and the seller.

Educational notes—scope of Part II of Section 11—paragraph 11.51

Contracts to buy or sell a non-financial item are also accounted for as financial instruments within the scope of Part II of Section 11 if they can be settled net in cash or another financial instrument or by exchanging financial instruments as if the contracts were financial instruments. For example, a contract for the purchase of a commodity at a future date which allows the parties to settle net in cash. At settlement date, the parties would exchange in cash the value of the difference between the price specified in the contract and the spot price on settlement date.

However, paragraph 11.51 specifies that even contracts that can be settled net in cash are outside the scope of Part II of Section 11 if they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (sometimes called 'the own use exception'). For example, following the example in the previous paragraph, even though the contract can be settled net in cash, if the buyer entered into the contract because it wants to use the commodity in its business and that is still the case, then the contract will not be within the scope of Part II of Section 11.

Examples—scope of Part II of Section 11—paragraph 11.51—contracts to buy or sell non-financial items (net settlement and expected usage exemption)

Ex 118 An SME enters into a contract to purchase one million kilograms of copper in 12 months at a fixed price, in accordance with its expected usage requirements (a fixed price forward contract). The contract permits the SME to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the spot price of copper at the end of the contract.

If the SME entered into the contract because it wants the copper to use in its business, and this is still the case, the contract satisfies the exception from the inclusion in paragraph 11.51 and, therefore, is not within the scope of Part II of Section 11.

Ex 119 An SME enters into a contract to purchase 10,000 kilograms of bananas in 12 months. Over the shelf life of those bananas, the SME expects to sell between 9,000 and 10,000 kilograms of the bananas in its shops. Any excess/unsold bananas are either treated as waste or are given to the local animal charity.

The contract is not within the scope of Part II of Section 11, because it was entered into based on the SME's expected purchase/usage requirements, and so satisfies the exception from the inclusion in paragraph 11.51. The SME sells the bananas in the normal course of its business.

Ex 120 **SME A, a company manufacturing bicycles, was concerned about the future price of rubber. Consequently, it entered into a fixed-price forward contract to purchase 5,000 bicycle tyres, 1,000 in each of five sizes, in 10 months for CU20,000.**

The tyres, when purchased, will be recognised as inventory to be used in the manufacture of bicycles.

The contract is not within the scope of Part II of Section 11, because it was entered into based on the SME's expected purchase/usage requirements. The SME will use the tyres in the normal course of its business manufacturing bicycles.

Initial recognition of financial assets and liabilities

11.52 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.

Educational notes—initial recognition

Planned future transactions, no matter how likely, are not financial assets and financial liabilities because the entity has not become a party to a contract.

A forward contract within the scope of Part II of Section 11 including those described in paragraph 11.51, such as a firm commitment to buy or sell non-financial items that can be net settled, is recognised as an asset or a liability on the commitment date. When an entity becomes a party to a forward contract, the fair values of the rights and obligations are often equal, so consequently, the net fair value of the forward contract at that point is often zero. If the net fair value of the rights and obligations is not zero, the contract is recognised as an asset or liability.

Initial measurement

11.53 When a financial asset or financial liability is recognised initially, an entity shall measure it at its **fair value**, which is normally the transaction price.

Examples—initial recognition and initial measurement

Ex 121 **The facts are the same as in Example 111. That is, SME A, a company manufacturing bicycles, contracted on 1 November 20X4 to purchase a new machine from an overseas supplier. The machine is expected to be ready for delivery on 31 January 20X5, at which time, SME A is contractually required to pay the manufacturer the full price of the machine, FCU10,000. SME A is concerned about the effect of fluctuating exchange rates on its cash flows. Consequently, on 1 November 20X4 SME A also entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X5.**

The contract to purchase the machine is not within paragraph 11.50 or 11.51, the contract is outside the scope of Part II of Section 11.

The forward contract to purchase FCU is within the scope of Part II of Section 11, because it is a financial instrument and it is neither listed in paragraph 11.8 nor exempt under paragraph 11.49. The forward contract for FCU will therefore be recognised on 1 November 20X4 when SME A becomes a party to the forward contract; and it will be initially measured at its fair value. If Bank B, the party with whom SME A enters into the forward contract for FCU, is an independent third party, the price paid by SME A is likely to be the fair value of the forward FCU contract. In this forward contract, the exchange rate is FCU2.00:CU1.00 (SME A will pay CU5,000 to receive FCU10,000) and, if this is priced at fair value, the forward rate will be based on the spot price at 1 November 20X4 (for example, FCU1.98:CU1.00) adjusted to reflect the three-month interest rates in the two jurisdictions. Consequently, at 1 November 20X4, CU5,000 payable in three months is equal to FCU10,000 receivable in three months. In this example it is assumed that the fair value of the forward contract at inception, and thus the price paid to Bank B, was nil.

Ex 122 **SME A, a company manufacturing bicycles, had some surplus cash and decided to invest it in a publicly listed bicycle manufacturer. On 12 June 20X5, it purchased 1,000 listed convertible preference shares for CU5,000.[5] SME A incurred a transaction fee and stamp duty on the purchase of CU100.**

SME A will recognise the shares on 12 June 20X5. They have to be initially measured at fair value. Paragraph 12.8 explains that transaction costs are ignored from the measurement of the fair value of assets and liabilities. Consequently, SME A will measure the shares when it recognises them on 12 June 20X5, at CU5,000 (not CU5,100—see paragraph 12.8).

5 The voting rights attached to the 1,000 shares purchased do not result in SME A having significant influence, joint control or control over the bicycle manufacturer.

Ex 123 The facts are the same as in Example 110. That is, on 1 January 20X4, SME A, a company manufacturing bicycles, took out a CU100,000 five-year variable-interest rate loan from Bank B. Interest is payable on the loan at SONIA plus 100 basis points. SONIA increased twice during 20X6.

Concerned about rising expectations that interest rates are to increase again in the near future, on 1 January 20X7, SME A takes out an interest rate swap with Bank C for the final two years of the loan; the combined effect of the swap and the loan is a loan with interest fixed at 4.5% for 20X7 and 20X8. The swap, which assumes a principal amount of CU100,000, specifies that SME A pays 3.5% fixed interest and receives variable interest calculated at SONIA. SONIA is reset quarterly under both the loan and the swap.

As explained in Example 110, the loan is within the scope of Part I of Section 11 throughout its full five-year life, whereas the swap is accounted for under Part II of Section 11.

The swap will be recognised on 1 January 20X7 and initially measured at its then fair value. If Bank C, the party with whom SME A enters into the swap, is an independent third party, the price paid by SME A, if any, is likely to be the fair value of the swap.

Subsequent measurement

11.54 At the end of each **reporting period**, an entity shall measure all financial instruments within the scope of Part II of Section 11 at fair value and recognise changes in fair value in **profit or loss**, except as follows:

(a) some changes in the fair value of **hedging instruments** in a designated hedging relationship are required to be recognised in **other comprehensive income** by paragraph 11.69; and

(b) **equity** instruments that are not **publicly traded** and whose fair value cannot otherwise be measured reliably without undue cost or effort and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.

11.55 **Dividends** are recognised in profit or loss only when:

(a) the entity's right to receive payment is established;

(b) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(c) the amount of the dividend can be measured reliably.

Examples—subsequent measurement

Ex 124 **The facts are the same as in Examples 111 and 121. That is, SME A, a company manufacturing bicycles, contracted on 1 November 20X4 to purchase a new machine from an overseas supplier. The new machine is expected to be ready for delivery on 31 January 20X5, at which time, SME A is contractually required to pay the manufacturer FCU10,000, the full price of the machine. SME A is concerned about the effect on its cash flow of fluctuating exchange rates. Consequently, on 1 November 20X4 it also entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X5. The forward contract to purchase FCU had a nil fair value when entered into on 1 November 20X4, but two months later, at SME A's year-end (31 December 20X4), it had a negative fair value of CU(97).**

SME A does not apply hedge accounting.

The forward contract to purchase FCU is recognised on 1 November 20X4 when SME A becomes a party to the forward contract. However, because the fair value of the contract on that date was nil, it was initially measured at nil.

SME A subsequently measures the forward contract as a financial liability at CU97 and recognises an expense of CU97, in profit or loss.

Educational notes—subsequent measurement (equity instruments)

Financial instruments within the scope of Part II of Section 11 are measured at fair value with changes in fair value recognised in profit or loss. The exception to this principle applies to equity instruments not publicly traded and whose fair value cannot otherwise be measured reliably without undue cost or effort and to contracts linked to such instruments that, if exercised, will result in delivery of such instruments—for example, an option to purchase unquoted shares whose fair value cannot be measured reliably without undue cost or effort. The exception extends to contracts resulting in delivery of such shares, because if the shares cannot be measured reliably, a derivative for such shares also cannot be measured reliably.

If the entity does not measure such shares at fair value, paragraph 11.54 requires them to be measured at cost less impairment. The requirement for impairment in paragraphs 11.21–11.26 (see paragraph 11.59) applies. If the entity does not have access to the company's budgets, management accounts or other internal information, other sources of information that might be useful in determining whether there has been any impairment include the company's financial statements. In addition, as explained in paragraph 11.23, significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the company operates may provide evidence of impairment.

11.56 If a reliable measure of fair value is no longer available without undue cost or effort for an equity instrument, or a contract linked to such an instrument that if exercised will result in the delivery of such instruments, that is not publicly traded but is measured at fair value through profit or loss, its fair value at the last date that the instrument was reliably measurable without undue cost or effort is treated as the cost of the instrument. The entity shall measure the instrument at this cost amount less impairment until it is able to determine a reliable measure of fair value without undue cost or effort.

Educational notes

The requirement to measure at cost less impairment discussed in paragraph 11.54(b) applies when fair value cannot be measured reliably for an unquoted equity instrument or an option or a forward for such an instrument. When such an instrument has been measured at fair value in earlier periods but its fair value can no longer be measured reliably without undue cost or effort, paragraph 11.56 specifies that the cost for this purpose is deemed to be the last reliable measurement of fair value.[6] Any fair value gains and losses that had previously been recognised in profit or loss for that instrument must not be reversed. If there is objective evidence of impairment of the instrument, the requirements of impairment in paragraphs 11.21–11.26 apply.

Fair value

11.57 An entity shall apply the guidance on fair value in Section 12 to fair value measurements in accordance with Section 11.

Educational notes

Guidance on measuring fair value is in Section 12 *Fair Value Measurement*.

11.58 The fair value of a financial liability that is due on demand is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Example—financial liability due on demand

Ex 125 **On 1 January 20X4 SME A borrows CU100,000 from a bank with a maximum term of five years and 'interest' payments indexed to the price of oil. The bank can demand that SME A repay the debt instrument in full at any time. Because the interest payments are indexed to the price of oil and are neither fixed nor referenced to a quoted or observable interest rate, the debt instrument is within the scope of Part II of Section 11 rather than within the scope of Part I of Section 11.**

On 31 December 20X4, the fair value of an identical financial liability with interest payments indexed to the price of oil but without a demand feature, is CU90,000. This reflects a steep fall in the price of oil that has resulted in interest being paid at less than a market rate.

The bank has not indicated that it would demand immediate repayment.

At 31 December 20X4 SME A measures the debt instrument at CU100,000 because of the demand feature. It is not discounted because the full amount, CU100,000, is repayable immediately, if demanded.

6 This is a change in circumstance. It is not a change in accounting policy.

Ex 126 **The facts are identical to those in Example 125, except the debt instrument is repayable in full on demand at any time after 31 December 20X6 (rather than at any time).**

At 31 December 20X4 SME A measures the debt instrument at the present value of CU100,000 discounted back from 1 January 20X7 (which is the earliest date that the bank could demand immediate repayment) if this is higher than the fair value of an identical financial liability without a demand feature. For example, if the present value of CU100,000 discounted back from 1 January 20X7 is CU91,000, the debt instrument will be measured at CU91,000 whereas if the present value of CU100,000 discounted back from 1 January 20X7 is CU89,000, the debt instrument will be measured at CU90,000.

Impairment of financial assets measured at cost or amortised cost

11.59 An entity shall apply the guidance on impairment in paragraphs 11.21–11.26 to financial assets measured at cost less impairment in accordance with Part II of Section 11.

Educational notes

The only financial instruments within the scope of Part II of Section 11 to which paragraph 11.59 applies are equity instruments not publicly traded and whose fair value cannot otherwise be measured reliably without undue cost or effort, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments.

At the end of each reporting period, an entity must assess whether there is objective evidence of impairment of any of these instruments; for example, the introduction of a new competitor or a competing product might have an adverse effect on the investee's profitability and thus on the value of its shares.

See guidance on impairment in earlier sections of this module on Part I of Section 11.

Derecognition of a financial asset or financial liability

11.60 An entity shall apply the **derecognition** requirements in paragraphs 11.33–11.38 to financial assets and financial liabilities to which Section 11 applies.

Educational notes

Earlier sections of this module (Part I of Section 11) provide explanations and examples on how to apply paragraphs 11.33–11.38. These paragraphs apply equally to instruments that are outside the scope of Part I of Section 11 and within the scope of Part II of Section 11.

The following examples illustrate how the derecognition requirements apply to financial instruments within the scope of Part II of Section 11.

Example—continued recognition of a financial asset

Ex 127 **SME Z transfers its holding of 1,000 convertible preference shares in Company C to a bank for CU575. The shares, which are not listed or traded on any securities exchange, are measured at fair value under Part II of Section 11 and have a fair value of CU600 on the transfer date. SME Z had paid CU500 to purchase the shares 18 months earlier. On transfer of the shares SME Z provides the bank with a put option that expires in 60 days. At the end of 60 days the bank may exercise the put option and sell the shares back to SME Z for CU585. In addition, SME Z has a call option that also expires after 60 days; at the end of 60 days SME Z may exercise the call option and buy the shares back from the bank for CU585.**

If, after 60 days, the fair value of the shares is below CU585, it is expected that the bank will exercise its put option and sell the shares back to SME Z. On the other hand, if the fair value of the shares is above CU585, it is expected that SME Z will exercise its call option and purchase the shares back from the bank. Either way, at inception, it is anticipated that SME Z will own the shares again after 60 days. Consequently, SME Z has retained substantially all of the risks and rewards of ownership of the shares. SME Z does therefore not recognise the shares.

Instead, the transaction is accounted for as a 60-day loan of CU575. The loan is secured by the shares. Interest of CU10 (CU585–CU575) is payable during the 60-day period and is amortised to profit or loss using the effective interest rate method. If the full 60-day period falls within one accounting period, the CU10 will be recognised in profit or loss in full in that period.

Example—derecognition of a financial asset

Ex 128 **The facts are the same as in Example 127. However, in this example, the bank pays CU600 for the shares, SME Z does not have a call option, and at the end of 60 days the bank may exercise the put option and sell the shares back to the SME for CU600.**

At inception, it is uncertain whether the put option will be exercised by the bank; it is priced at an amount equal to fair value at the date of sale. In addition, SME Z does not hold a call option. Consequently, SME Z has retained some of the risks and rewards of ownership; if the fair value of the shares falls below CU600, the bank may sell the shares back to SME Z, but equally the bank may choose not to sell them back to SME Z (for example, the bank might have already sold the shares to a third party).

Because SME Z has retained some significant risks and rewards of ownership, paragraph 11.33(c) requires SME Z to consider whether it has transferred control of the shares to the bank by determining whether the bank 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 instance, the bank does have such a practical ability; there is no call option so it cannot be compelled by SME Z to sell the shares back to SME Z and its put option is not priced in a way to make it highly likely that it would be exercised by the bank, such as if it were priced at a large premium above the transaction date fair value. If it were priced in such a way that the bank expected to exercise the option, then the bank would either not sell the shares or it would sell them with restrictions attached to ensure that it received the shares back after 60 days so that it could exercise its put option and sell the shares back to SME Z. The fact that the bank may or may not choose to sell the shares is not relevant; it is whether the bank has the practical ability to do so that is important.

In this example, derecognition is appropriate because SME Z has transferred control of the shares to the bank. Consequently, SME Z must derecognise the shares and recognise separately the written put option, that is, the option of the bank to put (sell) the shares back to SME Z for CU600 in 60 days' time.

Hedge accounting

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

Educational notes

In some instances entities enter into transactions with the aim of reducing their exposure to a specified risk or to reduce the variability in cash flows. For example, an entity may have a variable rate bank loan, but has become concerned that interest rates may rise in the near future. It, therefore, enters into an interest rate swap with a different bank, in which it pays a fixed interest and receives a variable interest. The net effect, assuming the same principal amount, is that the entity will pay a fixed rate of interest—see Examples 110 and 123. When an entity enters into a transaction with another party to reduce or eliminate its exposure to a particular risk or to the variability in cash flows, that transaction is known as a hedging transaction.

In some hedging transactions, the gain or loss attributable to the risk being hedged in the hedged item is accounted for applying the relevant requirements of the Standard, in the same period as the gain or loss on the hedging instrument. In such cases, there are no additional recognition and measurement requirements that apply. For example, if a derivative is used to hedge a debt instrument that is within the scope of Part II of Section 11, both the derivative and the debt instrument would be required to be measured at fair value with changes in fair value being recognised in profit or loss. Consequently, if the hedge is fully effective, the effect on profit or loss of the hedging instrument is equal and opposite to the effect of the hedged risk in the hedged item, thereby 'cancelling out or offsetting' the effect on profit or loss of the hedged risk.

In other hedging transactions, the recognition and measurement for the financial instrument acquired to hedge the exposure (the hedging instrument) and the underlying exposure being hedged (the hedged item) will affect profit or loss in different periods. For example, if a derivative is used to hedge a debt instrument that is within the scope of Part I of Section 11. Some view this as an 'accounting mismatch', because, although there is an economic hedge, it is not reflected in the accounting. Consequently, Part II of Section 11 contains some requirements for hedge accounting designed to 'correct' this timing mismatch. These requirements modify the normal basis for recognising income and expenses on associated hedging instruments and/or hedged items so that both are recognised in profit or loss in the same accounting period. Hedge accounting does not change the overall performance of the entity; it affects only the timing and presentation of income and expenses in profit or loss.

Part II of Section 11 limits the circumstances in which hedge accounting can be applied by specifying four conditions. One of the conditions is that the hedging instrument must be one of four specific instruments and meet a number of criteria. Another of the conditions is that the hedged risk must be one of five specified risks (in paragraph 11.63). Consequently, an entity may have a hedge that does not qualify for hedge accounting in accordance with Part II of Section 11 despite being part of a valid economic hedging strategy.

If an entity wishes to apply hedge accounting to one or more of its hedging transactions, the entity must comply with the four circumstances in paragraph 11.62. Entities are not required to apply hedge accounting to all their hedging transactions that would otherwise meet the criteria in paragraph 11.62; they can choose to apply hedge accounting to only some, or none, of those transactions. If the entity does not designate and document a hedging relationship for a particular transaction applying paragraph 11.62(a), hedge accounting would not be permitted to be applied for that transaction. On the other hand, if the entity does designate and document a hedging relationship applying paragraph 11.62(a) for a different transaction, hedge accounting would be permitted for that transaction, assuming all the other conditions are satisfied.

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

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

(b) the hedged risk is one of the risks specified in paragraph 11.63.

(c) the hedging instrument is as specified in paragraph 11.64.

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

Educational notes

Hedging documentation

Part II of Section 11 does not provide any specific format for the hedging documentation required by paragraph 11.62(a). The only requirements are that there is documentation that specifies:

- the risk being hedged;
- the hedged item; and
- the hedging instrument.

By documenting these items, it will be clear that the risk in the hedged item is the risk being hedged by the hedging instrument.

Part II of Section 11 limits the risks that can be hedged if hedge accounting is to be applied. Consequently, the risk being hedged must be one of the five listed in paragraph 11.63. One of the risks for which hedge accounting is permitted is interest rate risk of a debt instrument measured at amortised cost. For example, if an entity takes out a loan paying a fixed rate of interest of 7%, which includes a credit spread of 2%, it may, for example, choose to hedge the fixed interest excluding the credit spread by taking out an interest rate swap to swap fixed 5% for variable equal to SONIA. If so, it would be necessary to document that the risk being hedged was the fixed interest excluding the credit spread.

Hedge effectiveness

Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. For the purposes of assessing hedge effectiveness, only the change in the fair value or cash flows of the hedged item that are attributable to the hedged risk are considered.

To apply hedge accounting, an entity is required to assess whether it expects the hedging relationship to be highly effective in achieving offset in the future. The Standard does not include guidance on when a hedging relationship is considered to be highly effective.

If a hedging transaction qualifies for hedge accounting, but, at some future point, ceases to meet the conditions in paragraph 11.62, the hedge accounting must be discontinued (see paragraphs 11.67 and 11.68). Consequently, the assessment of whether the hedging relationship is expected to be highly effective needs to be assessed over the life of the hedging relationship. For example, a hedge involving a counterparty may initially be expected to be highly effective, but if the counterparty's creditworthiness deteriorates, the hedge may become ineffective because the changes in the fair value of the hedging instrument would be affected by the changes in credit risk, which will not necessarily be offset by the changes in the fair value of the hedged item attributable to the hedged risk. If so, the entity would need to assess whether the ineffectiveness is such that the hedge is no longer expected to be highly effective.

Because the continuing application of hedge accounting is based on the conditions in paragraph 11.62 continuing to be met, an entity might, as a minimum, assess expected effectiveness when preparing the annual financial statements.

Part II of Section 11 contains no requirements for assessing expected hedge effectiveness. When performing such an assessment, an entity may, for example, use one or more of the following approaches:

(a) comparing the principal terms of the hedging instrument with those of the hedged item. If the principal terms of the hedging instrument match those of the hedged item there would usually be an expectation of high effectiveness. This is possibly the most straightforward way of assessing hedge effectiveness and is expected to be the one used most often, because matching the principal terms does not require any calculations.

The comparison would be of terms such as notional and principal amount, term, payment timing, repricing dates, denominated currency and maturity.

The principal terms of the hedging instrument and hedged items are those that are critical to the assessment of hedge effectiveness, that is, those that relate to the risk being hedged. For example, if a variable-rate foreign currency debt instrument is the hedged item, changes in the cash flows may arise because of changes in exchange rates as well as changes in interest rates. However, if the hedging instrument is an interest rate swap and hedges only the interest rate risk associated with the debt instrument, changes in cash flows due to exchange rate movements would not be considered; therefore exchange rate movements would not lead to the hedging relationship being ineffective.

(b) employing simple mathematical models such as ratio analysis (sometimes called the dollar offset test) can be used. Ratio analysis involves comparing:

- changes in the fair value or cash flows of the hedging instrument; with
- changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk.

This approach can be used to assess the effectiveness of a hedge prospectively by considering the effect of a hypothetical change in the underlying hedged risk on both the hedging instrument and the hedged item (for example, a 5% change in the exchange rate if foreign exchange risk is being hedged or a movement of 1% in the interest rate, such as SONIA, if interest rate risk is being hedged).

(c) demonstrating a high statistical correlation between the fair value or cash flows of the hedged item that are attributable to the hedged risk and those of the hedging instrument. Regression analysis is one way to demonstrate such a statistical correlation.

The appropriateness of a given approach in assessing expected hedge effectiveness will depend on the nature of the risk being hedged, the type of hedging instrument and the information available. The approach in assessing hedge effectiveness must be reasonable, be applied consistently over the period of the hedging relationship and be consistent with other similar hedges, unless different methods are explicitly justified. Depending on which approach is used, it might also be appropriate to assess whether credit risk changes the expected hedge effectiveness.

11.63 This Standard permits hedge accounting only for the following risks:

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

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

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

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

Foreign exchange risk of a debt instrument measured at amortised cost is not in the list because hedge accounting would not have any significant effect on the **financial statements**. Basic accounts, notes and loans receivable and payable are normally measured at amortised cost (see paragraph 11.5(d)). This would include payables denominated in a foreign currency. Paragraph 30.10 requires any change in the **carrying amount** of the payable because of a change in the exchange rate to be recognised in profit or loss. Consequently, both the change in fair value of the hedging instrument (the cross-currency swap) and the change in the carrying amount of the payable relating to the change in the exchange rate would be recognised in profit or loss and should offset each other except to the extent of the difference between the spot rate (at which the **liability** is measured) and the forward rate (at which the swap is measured).

Educational notes

Part II of Section 11 permits hedge accounting only for changes in the fair value or cash flows of the hedged item that are attributable to the specific risks listed in paragraph 11.63. For example, paragraph 11.63(a) permits hedge accounting for the interest rate risk of a debt instrument measured at amortised cost. Hedge accounting is therefore permitted for hedges of changes in the cash flows of variable rate debt that are due to changes in interest rates. Hedge accounting is also permitted for changes in the fair value of fixed rate debt as a result of changes in interest rates, but not for changes in the fair value that are due to other risks, such as credit risk or foreign exchange risk.

Firm commitments

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates (see Glossary). Therefore, a firm commitment must have a fixed quantity, a fixed price and a fixed timing. For example, if a company signs a contract to sell a machine to a customer on a fixed date in the future for CU10,000, both the company and the customer have a firm commitment. Because a firm commitment is a binding agreement, it is usually legally enforceable.

Forecast transactions

A forecast transaction is defined as an uncommitted but anticipated future transaction (see Glossary). For example, if a company anticipates obtaining a loan in six months to finance an expansion of its business, it has a forecast transaction. Paragraph 11.63 permits hedge accounting only for forecast transactions considered highly probable. The term 'highly probable' is defined as 'significantly more likely than probable' (see Glossary) and indicates a much greater likelihood of occurrence, that is, the chances of the transaction occurring is considered to be significantly greater than a 50% chance.

Examples of circumstances that may affect the likelihood that a transaction will occur include the following:

(a) the frequency of similar past transactions;

(b) the financial and operational ability of the entity to carry out the transaction;

(c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short term only to process a particular type of commodity);

(d) the extent of loss of or disruption to operations that could result if the transaction does not occur;

(e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash in a forecast transaction may have several ways of doing so, ranging from a short-term bank loan to an issue of ordinary shares); and

(f) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable. For example, a transaction forecasted to occur in five years may be less likely to occur than a transaction forecast to occur in one year. In addition, other factors being equal, the greater the quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 350,000 units in the next month when sales for the past three months have averaged 95,000 units per month. A sales forecast of 100,000 units in proportion to the average sales of 95,000 units is more likely than 350,000 units.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question an entity's ability to predict forecast transactions accurately and thus whether hedge accounting should be applied in the future for similar forecast transactions.

If a forecast transaction is being hedged it must be identifiable and documented in such a way that when a transaction occurs it is clear whether or not it is the hedged transaction. For example, it is possible to hedge the sale of the first 15,000 units of a specific product during a specific three-month period. However, the last 15,000 units of that product sold during a three-month period cannot be hedged, because it is not possible to identify, at the time of sale, which are the last 15,000 units sold.

An entity is not required to predict and document the exact date when a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, in order to assess whether a hedging relationship is expected to be highly effective. To assess whether a hedging relationship is expected to be highly effective, it is necessary to ensure that changes in the fair value of the expected cash flows associated with the hedged risk are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur in close proximity to each other.

Net investment in a foreign operation

An entity's net investment in a foreign operation is the amount of the entity's interest in the net assets of that operation. A foreign operation may be a subsidiary, associate, joint arrangement or branch (see paragraph 30.5). In accordance with Part II of Section 11, the foreign exchange risk in a net investment in a foreign operation may be 'hedged'.

Hedge accounting for the foreign exchange risk in a net investment in a foreign operation is relevant when the operation has been consolidated or has been accounted for using the equity method; because in these instances, exchange differences arising when translating the operation's net assets are recognised in other comprehensive income. Without hedge accounting, the gain or loss on the hedging instrument would be recognised in profit or loss, creating a mismatch, with one being recognised in other comprehensive income and the other in profit or loss. The educational module on Section 30 focuses on a net investment in a foreign operation in more detail. Paragraph 11.69 sets out the requirements for net investment hedges.

Paragraph 30.12 of the Standard explains that when an entity has a monetary item receivable from or payable to a foreign operation and settlement of the monetary item is neither planned nor likely to occur in the foreseeable future, that monetary item is, in substance, a part of the entity's net investment in the foreign operation. See Module 30 for more information. Paragraph 30.13 requires the exchange differences on any such monetary items to be recognised in other comprehensive income in the entity's consolidated financial statements. Such monetary items, therefore, form part of the net investment that can be hedged.

Examples of hedged risks permitted by paragraph 11.63

Examples of hedged risks permitted by paragraph 11.63 that expose the entity to a risk of changes in future cash flows include:

- **Interest rate risk of a debt instrument measured at amortised cost (paragraph 11.63(a))**
  With variable rate debt instruments, the entity is exposed to the risk of changes in future interest payments (cash outflows or inflows) due to changes in market interest rates. For example:
  - if the entity has a loan with interest payable at SONIA plus 200 points and SONIA increases, the entity will be required to pay more interest; or
  - if the entity has an investment in a variable-rate bond with interest payments linked to SONIA, and SONIA decreases, the entity will receive less interest income.

- **Foreign exchange risk in a firm commitment (paragraph 11.63(b))**
  A firm sales commitment exposes the entity to the risk of changes in receipts to the extent they are not fixed in the reporting entity's functional currency in the contract. For example, an entity may enter into an agreement to sell goods to an overseas customer at a fixed amount of foreign currency in three months. For the next three months, the entity is exposed to the risk of movement in the exchange rate between the foreign currency and its functional currency, that is, the currency of the primary economic environment in which the entity operates. If the foreign currency weakens against the entity's functional currency, the entity will, on sale, receive a lower cash inflow when translated into the functional currency.
- **Commodity price risk in a highly probable forecast purchase (paragraph 11.63(c))**
  A highly probable purchase transaction exposes the entity to the risk of changes in expected payments. For example, if the entity needs to buy copper for use within the business and it intends to make its next purchase in three months, the entity is exposed to the risk of the price of copper rising significantly over the next three months, resulting in a higher cash outflow on purchase.

Examples of risks that are permitted to be hedged by paragraph 11.63 and that expose the entity to a risk of changes in fair value include:

- **Interest rate risk of a debt instrument measured at amortised cost (paragraph 11.63(a))**
  A fixed-rate debt instrument held as an investment exposes the entity to the risk of changes in the fair value of the debt instrument due to changes in market interest rates. For example, if market interest rates rise, the fair value of the fixed-rate debt instrument would fall. If the entity holds the instrument to maturity it is unaffected by changes in the fair value of the debt investment attributable to changes in interest rates. However, if the fixed-rate debt instrument is sold in the open market, any fall in fair value would result in a lower price on sale.
- **Commodity price risk on stocks held (paragraph 11.63(c))**
  Holding a commodity exposes an entity to the risk of changes in the fair value of the commodity due to changes in market price. If the entity holds a large inventory of gold and the price of gold falls, the fair value of the inventory will also fall.

11.64 This Standard permits hedge accounting only if the hedging instrument has all of the following terms and conditions:

(a) it is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract that is expected to be highly effective in offsetting a risk identified in paragraph 11.63 that is designated as the hedged risk;

(b) it involves a party external to the **reporting entity** (ie external to the **group** or individual entity being reported on);

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

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

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

(ii) the expected settlement of the commodity purchase or sale commitment; or

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

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

Educational notes

Paragraph 11.64(a)

Paragraph 11.63 limits the risks for which hedge accounting may be used when applying the Standard. Paragraph 11.64(a) similarly limits the instruments that can be used as hedging instruments when using hedge accounting. For example, one of the risks that paragraph 11.63 permits to be hedged is the foreign exchange risk in a highly probable forecast transaction. If an entity with a functional currency of CU has a highly probable forecast transaction in a foreign currency (FCU), such as a sale of goods, the entity could, under paragraph 11.64(a), use an FCU/CU swap or forward contract to hedge the sale, but it could not designate a loan in FCU as the hedging instrument, because paragraph 11.64(a) does not permit it.

Paragraph 11.64(b)

For hedge accounting, only hedging instruments with a counterparty external to the reporting entity, that is, external to the group or to the individual reporting entity, can be designated as hedging instruments. An entity within a consolidated group may enter into an instrument it wishes to designate as a hedging instrument with another entity in the group. However, that hedging instrument would be eliminated on consolidation. Consequently, it is not possible to use hedge accounting in the consolidated financial statements of the group. Hedge accounting may nevertheless be possible in the individual or separate financial statements of the first entity if the other entity is external to the first entity.

Paragraph 11.64(c)

The notional amount is the quantity of currency units, shares, bushels, pounds or other units specified in a financial instrument contract (see Glossary). In other words, the notional amount is an amount of currency; a number of shares; a number of units of weight; a number of units of volume; or other units specified in the contract. An entity may enter into an interest rate swap with a notional amount of CU10,000 that requires the entity to pay a fixed interest rate, for example 7.5%, and receive a variable rate of interest, for example three-month SONIA. Under the swap, regular net settlements would be calculated by applying the difference between 7.5% and three-month SONIA to the notional principal of CU10,000. For example, if SONIA is 7% during a three-month period then a net payment of CU12.5 (10,000 × (7.5 – 7%)) ÷ 4) is required by the entity under the swap for that three-month period.

Paragraph 11.64(d)

The maturity date of the hedging instrument must be on or before the date the hedged item matures; hedge accounting is not permitted if the hedging instrument matures later than the hedged item, because this would leave the entity exposed to risk once the hedged items matured. In contrast, an entity is permitted to designate a hedging instrument as hedging only a portion of the period to maturity of a hedged item. For example, an interest rate swap could be taken out to hedge the interest rate risk in the first six months of a two-year loan, but the first six months of a two-year interest rate swap could not be used to hedge the last six months of a loan.

Paragraph 11.64(e)

Hedge accounting is not permitted under Part II of Section 11 if the hedging instrument has prepayment, early termination or extension features.

Overall consideration

Hedge accounting is only permitted if an entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk.

The hedging instrument is likely to be effective if:

(a) the notional amount of the hedging instrument is equal to the designated amount of the principal or notional amount of the hedged item (see paragraph 11.64(c)); and

(b) the value of the principal terms of the hedging instrument and of the hedged item move in opposite directions—that is one rises as the other falls.

This is because the changes in fair value and cash flows attributable to the hedged risk are likely to fully offset each other. For example, an interest rate swap is likely to be an effective hedge for the fixed interest rate risk in a loan if the swap is to receive fixed interest and pay variable interest and the swap and the loan have the same notional and principal amounts; term; repricing dates; dates of interest and principal receipts and payments and basis for measuring interest rates. Similarly, when a commodity forward exchange contract is used to hedge the price risk in a highly probable forecast purchase of a commodity, the effectiveness of the hedging instrument is increased if the quantity of the commodity is the same in the forward contract as in the forecast purchase, the two are for the same grade of commodity, if relevant, and the delivery time and location are the same.

Sometimes the hedging instrument offsets only part of the hedged risk. For example, the hedge may not be fully effective if a loan's interest rate is periodically reset but the frequency of that reset does not match the term of the underlying interest rate of the swap.

Examples—hedged risks and hedging instruments

Ex 129 An SME acquires a 10% fixed-rate government bond with a term to maturity of 10 years. To hedge against fair value exposure on the bond associated with the interest payments until Year 5, the SME acquires a five-year, pay-fixed, receive-floating interest rate swap.

Interest rate risk is one of the risks that paragraph 11.63 permits to be hedged. Interest rate swaps are permitted hedging instruments, provided the conditions in paragraph 11.64(b)–(d) are met. An entity is permitted to designate a hedging instrument as hedging only a portion of the period to maturity of a hedged item. Provided the other conditions in paragraph 11.64 are met, the swap may be designated as hedging the exposure to fixed interest rate risk in the debt instrument for the five-year period.

Ex 130 An SME acquires a 10% fixed-rate government bond with a remaining term to maturity of six years. To hedge against fair value exposure on the bond associated with the interest rate payments for the six years, the SME acquires a 10-year, pay-fixed, receive-floating interest rate swap.

The SME is not permitted to apply hedge accounting to the hedging relationship between the interest rate swap and the government bond. Because the interest rate swap matures later than the government bond, the interest rate swap does not satisfy the condition in paragraph 11.64(d).

To qualify for hedge accounting, the SME should instead enter into a six-year pay-fixed, receive-floating interest rate swap, ensuring that the six-year swap meets the other conditions in paragraph 11.64.

Ex 131 An SME whose functional currency is the CU obtains from its bank a five-year fixed rate, foreign currency denominated loan for FCU10,000. The SME holds an FCU10,000 five-year fixed rate bond. Both the loan and bond meet the requirements to be measured at amortised cost under Part I of Section 11.

Can the SME designate its FCU loan as a hedging instrument for the foreign currency risk from its FCU bond and use hedge accounting?

No. The FCU loan is not one of the hedging instruments listed in paragraph 11.64(a); only specified derivatives are hedging instruments in applying the Standard.

Consequently, the SME cannot apply hedge accounting to this transaction. However, hedge accounting would not have had any significant effect on the SME's financial statements. The change in the amortised cost of both the FCU loan and the FCU bond relating to the change in the exchange rate would be recognised in profit or loss and would effectively offset each other in the same accounting periods.

Ex 132 **SME A, whose functional currency is the CU, enters into a contract with SME B, whose functional currency is the FCU, for the sale of 10 machines to SME B for FCU10,000, payable on delivery. Delivery will take place in eight months. At the same time it enters into the contract, SME A enters into a foreign currency forward exchange contract to sell FCU10,000 and buy CU15,000 in eight months.**

This sales contract is a firm commitment between SME A and SME B. Foreign exchange risk in a firm commitment is one of the risks that paragraph 11.63 permits to be hedged. The foreign currency forward exchange contract is a hedging instrument permitted by paragraph 11.64(a). Consequently, assuming the other criteria for hedge accounting are met, the foreign currency forward exchange contract can be designated as a hedging instrument to hedge the foreign currency risk of the firm commitment (the hedged item); thus, hedge accounting can be used.

Ex 133 **An SME whose functional currency is the CU obtains from its bank a five-year variable rate (linked to the FCU SONIA) foreign currency-denominated loan for FCU10,000, which meets the requirements in Part I of Section 11 to be measured at amortised cost. To hedge its exposure to interest rate movements, the SME enters into an interest rate swap to receive variable-rate interest (linked to the FCU SONIA) in FCU and pay 5% fixed-rate interest in FCU. The SME wishes to designate the swap as a hedge of the FCU interest rate risk on the loan.**

Paragraph 11.63 permits hedge accounting for the interest rate risk of a debt instrument measured at amortised cost. The swap is a hedging instrument permitted by paragraph 11.64(a) and consequently, assuming the other criteria for hedge accounting are met, hedge accounting is permitted.

Ex 134 **An SME regularly purchases sheets of steel as a raw material for use in production. The steel company agrees to sell steel sheets to the SME in four months at the market price at that date and the SME considers this to be a highly probable forecast transaction to buy steel. Because the SME is concerned that the price of the steel sheets will increase during that four-month period, the SME enters into a four-month forward contract indexed to the price of iron ore, a significant component of steel, which it intends to net settle. The SME wishes to designate the contract as a hedge of the price risk of the steel sheets it intends to purchase.**

Steel production generally constitutes a significant portion of the consumption of iron ore. Consequently, changes in the price of iron ore will affect changes in the price of steel, but are unlikely to account for the entire change in the price of the steel sheets. If the SME is able to demonstrate that the hedging instrument, the iron ore forward exchange contract, is expected to be highly effective in hedging the price risk linked to the purchase of the steel sheets, it will be able to designate the forward contract as a hedging instrument in the hedging transaction. Provided that the other conditions for hedge accounting are met, the SME can use hedge accounting in Part II of Section 11.

Ex 135 SME X, whose functional currency is LCX, has highly probable forecast purchases denominated in the local currency of Country Y (LCY).

SME X is a subsidiary of SME Z, which prepares consolidated financial statements in its functional currency, LCZ.

SME Z enters into a forward contract to hedge the change in LCY relative to LCX resulting from the highly probable forecast purchases of SME X.

Does this hedge qualify for hedge accounting in the consolidated financial statements of SME Z, or must SME X, which has the foreign currency exposure, be a party to the hedging transaction for the hedge to qualify?

The hedge can qualify for hedge accounting in the consolidated financial statements, provided that the other hedge accounting conditions in paragraphs 11.62–11.64 are met. In the consolidated financial statements, the reporting entity is the group; the group is exposed to the risk and holds the hedging instrument.

In SME X's separate financial statements, hedge accounting would not be appropriate because the hedging instrument is held by SME Z.

In SME Z's separate financial statements, hedge accounting would not be appropriate because the forecast transaction is expected by SME X.

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

11.65 If the conditions in paragraph 11.62 are met and the hedged risk is the exposure to a fixed interest rate risk of a debt instrument measured at amortised cost or the commodity price risk of a commodity that it holds, the entity shall:

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

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

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

Educational notes

Paragraph 11.65 covers the following two types of hedging transactions:

(a) An entity holds a fixed-rate debt instrument and enters into an interest rate swap, which hedges the risk of changes in the fair value of the debt due to changes in interest rates.

An entity may enter into an interest rate swap on a debt instrument that is expected to be held to maturity (that is, the entity will not be affected by changes in the fair value of the instrument) if it wishes to swap the fixed interest payments for variable interest payments. For example, the entity may want to offset the variable cash flows of the swap with other payments or receipts on other instruments linked to variable rates.

If the fixed-rate debt instrument is a financial liability, for example, a fixed-rate bank loan, interest at the fixed rate will be paid. Consequently, the entity would enter into a pay-variable, receive-fixed interest rate swap. The net effect of the loan and swap will be that the entity would pay interest at the variable rate (this may be the variable rate plus a number of basis points, to take into account the entity's credit rating).

If the fixed rate debt instrument is a financial asset, for example, an investment in fixed-rate bonds, a fixed amount of interest income will be received. Consequently, the entity would enter into a pay-fixed, receive-variable interest rate swap. The net effect of the bonds and swap will be that the entity would receive interest income at the variable rate.

(b) An entity holding a particular type of commodity as inventory enters into a commodity forward contract (to sell) to hedge the risk of decreases in the fair value of the commodity due to price risk over the period of the forward contract. On maturity of the forward contract, the entity, if it settles the forward contract, will pay or receive the difference between the spot price of the commodity at maturity and the fixed price under the forward contract. The forward contract provides a hedge against the inventory's exposure to price risk.

The hedges in (a)–(b) are accounted for as follows:

The hedging instrument

Hedge accounting under paragraph 11.65 affects only the hedged item and has no impact on the hedging instrument. The hedging instrument will be accounted for the same way, regardless of whether it is included as part of a designated hedging relationship applying paragraph 11.65. The hedging instruments permitted to be used in Part II of Section 11 are derivatives. For that reason, they will be accounted for at fair value, with gains or losses recognised in profit or loss of the period in which the change in fair value occurs.

In addition, when the fixed interest rate risk of a debt instrument is hedged as in (a), the periodic net cash settlements on the swap are recognised in profit or loss when they accrue. See the illustrative journals; this may be incorporated with the recognition of the change in fair value of the swap, or it may be recognised separately, in which case, the journal for the change in fair value of the swap is adjusted accordingly.

The hedged item

Hedge accounting applying paragraph 11.65 involves changing how the hedged item is accounted for, that is, the hedge accounting overrides the 'normal' accounting for the hedged item. In (a)–(b), if an entity applies hedge accounting to a hedging relationship, the changes in the fair value of the hedged item attributable to the hedged risk are recognised in profit or loss and as an adjustment to the carrying amount of the hedged item (debt instrument or commodity) in the statement of financial position.

Hedge ineffectiveness

Because the change in fair value of the hedging instrument and the change in the fair value of the hedged item attributable to the hedged risk are both recognised in profit or loss, any hedge ineffectiveness (the extent to which changes in the fair value or cash flows of the hedged item and of the hedging instrument do not match) is automatically recognised in profit or loss in the period in which it occurs. This automatic recognition occurs regardless of whether the changes in the fair value of the hedging instrument are less than, or exceed, those changes in the fair value of the hedged item attributable to the hedged risk.

Examples—comparisons of not applying hedge accounting (Example 136) with applying hedge accounting (Example 137)

Ex 136 On 1 January 20X3 SME A took out a CU50,000 six-year fixed-rate bank loan with Bank B. One year later, on 1 January 20X4, concerned about press reports that interest rates would soon fall, SME A entered into an interest rate swap with another external party to convert the loan from a fixed-rate loan to a variable-rate loan, so that SME A's interest expense is now effectively at a variable rate. Further details about the loan and interest rate swap are:

- **SME A pays interest at an annual fixed rate of 5% in arrears on the bank loan. At 5%, the fixed interest rate on the loan is 100 basis points or 1% higher than the five-year swap rate as a result of SME A's credit rating.**
- **The swap is a five-year interest rate swap in which the SME will pay SONIA and receive a fixed 4% on a nominal value of CU50,000. The floating leg of the swap is reset on an annual basis on 31 December. The interest rate swap is on-market, and at inception has a fair value of zero. The swap does not have any prepayment, early termination or extension features.**

The combined effect of the loan and the swap is that, for the last five years of the loan, the SME pays variable rate interest equal to SONIA plus 1% on its loan of CU50,000.

SME A does not wish to apply hedge accounting to this transaction. Consequently, SME A neither designates nor documents the hedging relationship. SME A has a 31 December year-end. Transaction fees have been ignored for the purpose of this example.

Details about the swap are as follows:

	31 December 20X4 *CU*	*31 December 20X5* *CU*
Fair value at the beginning of the year	–	2,000
Fair value change in the year	2,500	(3,500)
Cash settlement during the year (received)/paid (interest rate is 3% (20X3) and 5% (20X4))	(500)	500
Fair value of interest rate swap asset/(liability) at end of year	2,000	(1,000)

Note: the figures in the table have not been calculated accurately and are for illustration purposes only.

The journal entries on initial recognition (1 January 20X3) of the transaction and subsequently are:

1 January 20X3

Loan

Dr Asset: financial asset—cash	CU50,000	
Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash.

31 December 20X3

Loan—amortised cost

Dr Expense: profit or loss—finance costs	CU2,500	
Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest.

At 31 December 20X3 the carrying amount of the loan is a liability of CU50,000.

1 January 20X4

Swap

As the swap has a fair value of zero on 1 January 20X4, no entries are required on initial recognition.

31 December 20X4

Loan—amortised cost

Dr	Expense: profit or loss—finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr	Asset: financial asset—swap	CU2,500	
	Cr Income: profit or loss— change in fair value of swap		CU2,500

To record the change in fair value of interest rate swap.

Swap—periodic net cash settlement (SONIA is 3%)

Dr	Asset: financial asset—cash	CU500	
	Cr Asset: financial asset—swap		CU500

To record the cash flow under the swap agreement (CU50,000 x (4% (fixed rate) – 3% (SONIA)).

At 31 December 20X4 the carrying amount of the loan is a liability of CU50,000 and the swap is an asset of CU2,000 (at fair value).

The net effect on profit or loss in 20X4 is nil, which is made up of CU2,500 finance costs minus a CU2,500 change in fair value of the swap.

31 December 20X5

Loan—amortised cost

Dr	Expense: profit or loss—finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr	Expense: profit or loss— change in fair value of swap	CU3,500	
	Cr Asset/Liability: financial asset/liability—swap		CU3,500

To record the change in fair value of interest rate swap

Swap—periodic net cash settlement (SONIA is 5%)

Dr	Liability: financial liability—swap	CU500	
	Cr Asset: financial asset—cash		CU500

To record the cash flow under the swap agreement (CU50,000 x (4% (fixed rate) – 5% (SONIA)).

At 31 December 20X5, the carrying amount of the loan is CU50,000 (financial liability) and the swap is a financial liability of CU1,000 (moved from a CU2,000 asset at 31 December 20X4).

The net effect on profit or loss in 20X5 is a debit of CU6,000, which is made up of CU2,500 finance costs plus a CU3,500 change in fair value of the swap.

Note: this example shows only the journal entries for the first three years of the loan and the first two years of the swap. If it showed the journal entries for all five years of the swap, it would show that the fair value of the swap at the end of the five years is zero and that the cumulative effect of the swap on profits over the five years equals the sum of the annual net cash settlements.

The entries recognised in profit or loss for the three years would be:

	20X3	**20X4**	**20X5**
Loan interest payable	(2,500)	(2,500)	(2,500)
Swap—change in fair value*	–	2,500	(3,500)
	(2,500)	–	(6,000)

*The change in fair value is the total change since the start of the accounting period. It is, therefore, made up of two elements:

	20X4	**20X5**
Attributable to the current accounting period (also equal to the net cash settlement accruing for the accounting period)	500	(500)
Attributable to the future periods	2,000	(3,000)
	(2,500)	(3,500)

This example shows the result of the SME taking out an interest rate swap as an economic hedge of the interest rate risk of its fixed-rate bonds. The swap has the effect of transforming a fixed-rate loan into a variable-rate loan. However, because the loan is accounted for at amortised cost and the swap is recognised at fair value each year, the resulting profits are volatile over the five-year period.

Ex 137 The facts are the same as in Example 136. However, in this example, SME A wishes to designate a hedging relationship between the interest rate swap and the interest rate risk of the loan in such a way as to qualify for hedge accounting. Consequently, on 1 January 20X4 SME A designates and documents the hedging relationship applying paragraph 11.62(a).

The journal entries on initial recognition (1 January 20X3) of the transaction and subsequently are:

1 January 20X3

Loan—amortised cost

Dr Asset: financial asset—cash	CU50,000	
Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash.

31 December 20X3

Loan—amortised cost

Dr Expense: profit or loss— finance costs	CU2,500	
Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest.

At 31 December 20X3 the carrying amount of the loan is a liability of CU50,000.

1 January 20X4

Swap

Because the swap has a fair value of zero on 1 January 20X4, no entries are required on initial recognition.

31 December 20X4

Loan—amortised cost

Dr Expense: profit or loss—finance costs	CU2,500	
Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest.

Hedge accounting: loan—change in fair value due to interest rate risk

Dr Expense: profit or loss—change in fair value (hedged item)	CU2,000	
Cr Liability: financial liability—loan		CU2,000

To record the change in fair value of the loan attributable to interest rate risk.

Swap—change in fair value (SONIA is 3%)

Dr	Asset: financial asset—swap	CU2,500	
	Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU500
	Cr Income: profit or loss—change in fair value (hedging instrument)		CU2,000

To record the change in fair value and the accrued net cash settlement of the interest rate swap.

Swap—periodic net cash settlement (SONIA is 3%)

Dr	Asset: financial asset—cash	CU500	
	Cr Asset: financial asset—swap		CU500

To record the cash flow under the swap agreement (CU50,000 x (4% (fixed rate) – 3% (SONIA)).

The net effect on profit or loss is that the SME has variable rate interest; it pays the bank fixed interest and the effect of the interest rate swap is to adjust that interest to a variable rate.

The net effect on profit or loss in 20X4, when SONIA is 3%, is a debit of CU2,000 (which comprises CU2,500 interest expense minus CU500 accrual for net cash payment on the swap, with the CU2,000 other change in fair value of the swap, and the CU2,000 change in fair value of the loan due to interest rate risk, netting to zero).

At 31 December 20X4 the carrying amount of the loan is a financial liability of CU52,000 (= CU50,000 + CU2,000) and the swap is a financial asset of CU2,000 (= CU2,500 – CU500).

31 December 20X5

Loan—amortised cost

Dr	Expense: profit or loss—finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest.

Hedge accounting: loan—change in fair value due to interest rate risk

Dr	Liability: financial liability—loan	CU3,000	
	Cr Income: profit or loss—hedge accounting effect		CU3,000

To record the change in fair value of the loan attributable to interest rate risk.

Swap—change in fair value (SONIA is 5%)

Dr	Expense: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)	CU500	
Dr	Expense: profit or loss—change in fair value (hedging instrument)	CU3,000	
Cr	Asset: financial asset—swap		CU2,000
Cr	Liability: financial liability—swap		CU1,500

To record the change in fair value and the accrued net cash settlement of the interest rate swap. The journal entry is split because the swap changes from an asset to a liability.

Swap—periodic net cash settlement (SONIA is 5%)

Dr	Asset: financial asset—swap	CU500	
Cr	Asset: financial asset—cash		CU500

To record the cash flow under the swap agreement (CU50,000 x (4% (fixed rate) – 5% (SONIA)).

The net effect on profit or loss is that the SME has variable-rate interest; it pays the bank fixed interest and the effect of the interest rate swap is to adjust that interest to a variable rate.

The net effect on profit or loss in 20X2, when SONIA is 5%, is a credit of CU3,000 (which comprises CU2,500 interest expense plus CU500 accrual for net cash payment on the swap, with the CU3,000 other change in fair value of the swap, and the CU3,000 change in fair value of the loan due to interest rate risk, netting to zero).

At 31 December 20X5 the carrying amount of the loan is a financial liability of CU49,000 (= CU50,000 minus CU1,000) and the swap is a financial liability of CU1,000 (= CU2,000 asset plus CU500 minus CU3,500).

The entries recognised in profit or loss for the three years illustrated would be:

	20X3	**20X4**	**20X5**
Loan interest payable	(2,500)	(2,500)	(2,500)
Loan—change in fair value	n/a	(2,000)	3,000
Swap—change in fair value:			
accrual for periodic net cash settlement	n/a	500	(500)
other change in fair value	n/a	2,000	(3,000)
	(2,500)	(2,000)	(3,000)

The swap was not taken out until 1 January 20X4. The net effect on profit or loss in 20X4 and 20X6 is still variable (although less variable than in Example 136, when hedge accounting was not applied), but that is because the combined effect of the loan and the swap is to create a loan with an effective interest rate variable at SONIA plus 1%.

11.67 The entity shall discontinue the hedge accounting specified in paragraph 11.65 if:

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

(b) the hedge no longer meets the conditions for hedge accounting specified in paragraph 11.62; or

(c) the entity revokes the designation.

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

Educational notes

Hedging instrument expires, is sold or terminated

The hedging instrument no longer exists and should be derecognised.

Hedged item is not sold, terminated or extinguished

If hedge accounting is discontinued without the hedged item being sold or extinguished, the hedged item ceases to be adjusted for future changes in its fair value attributable to the hedged risk. The cumulative adjustment to the hedged item, for changes in its fair value attributable to the hedged risk during the period of hedge accounting, remains part of the carrying amount of the hedged item until the hedged item is derecognised. It is treated as follows:

- If the hedged risk is the exposure to the commodity price risk of a commodity, the cumulative adjustment remains part of the carrying amount of the asset up to the date of its use, sale or impairment.
- If the hedged risk is the exposure to a fixed interest rate risk of a debt instrument measured at amortised cost, the cumulative adjustment is amortised through profit or loss using the effective interest method over the remaining life of the debt instrument.

Hedging instrument is not sold, terminated or extinguished

If the hedge no longer meets the conditions for hedge accounting specified in paragraph 11.62 but without the hedging instrument having expired, been sold or terminated (paragraph 11.67(b)), for example, if the hedging instrument is no longer expected to be highly effective, or if an entity revokes the hedge designation (paragraph 11.67(c)), the entity will still hold the hedging instrument. However, the entity should stop hedge accounting. The entity should continue to account for the hedging instrument applying Part II of Section 11, that is, at fair value with changes in fair value recognised in profit or loss. In addition, the entity should account for the hedged item as set out above.

Examples—discontinued hedge accounting

Ex 138 **The facts are the same as in Example 136, but the SME applies hedge accounting. At 31 December 20X5 the carrying amount of the loan is CU49,000 and the swap is a liability of CU1,000 (see Example 137). However, in this example, on 1 January 20X6 the SME decides to revoke the designation prospectively, but without closing out the swap.**

At 31 December 20X6 the swap has a fair value of CU600 (liability) and SONIA was 4.5%.

The journal entries on 31 December 20X6 are as follows:

31 December 20X6

Loan—amortised cost (see table at the end of this example)

Dr	Expense: profit or loss—finance costs	CU2,815	
	Cr Asset: financial asset—cash		CU2,500
	Cr Liability: financial liability—loan		CU315

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr	Liability: financial liability—swap	CU150[(a)]	
	Cr Income: profit or loss—change in fair value of swap		CU150

To record the change in fair value of interest rate swap.

(a) Change in fair value of swap = fair value at 31 December 20X6 (CU(600)) minus fair value at 31 December 20X5 (CU(1,000)) minus accrued net cash settlement (CU250) = CU150.

Swap—periodic net cash settlement (SONIA is 4.5%)

Dr	Liability: financial liability—swap	CU250	
	Cr Asset: financial asset—cash		CU250

To record the cash flow under the swap agreement (CU50,000 x (4% (fixed rate) – 4.5% (SONIA))

The carrying amount of the loan is no longer adjusted for changes in fair value attributable to interest rate risk, because hedge accounting has been discontinued.

At 31 December 20X6 the carrying amount of the loan is CU49,315 and the swap is a liability of CU600.

The calculation of the revised effective interest rate is:

Year	*Carrying amount at 1 January*	*Interest at 5.7447%*[(a)]	*Cash inflow*	*Carrying amount at 31 December*
20X6	49,000	2,815	(2,500)	49,315
20X7	49,315	2,833	(2,500)	49,648
20X8	49,648	2,852	(52,500)	–

(a) The effective interest rate of 5.7447% is the rate that discounts the expected cash flows on the loan to the carrying amount, CU49,000, on 31 December 20X5.

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

11.69 If the conditions in paragraph 11.62 are met and the hedged risk is:

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

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

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

(d) the foreign exchange risk in a net investment in a foreign operation, the entity shall recognise in other comprehensive income the portion of the change in the fair value of the hedging instrument that was effective in offsetting the change in the fair value or expected cash flows of the hedged item. The entity shall recognise in profit or loss in each period any excess (in absolute amount) of the cumulative change in the fair value of the hedging instrument over the cumulative change in the fair value of the expected cash flows of the hedged item since inception of the hedge (sometimes called hedge ineffectiveness). The hedging gain or loss recognised in other comprehensive income shall be reclassified to profit or loss when the hedged item is recognised in profit or loss, subject to the requirements in paragraph 11.71. However, the cumulative amount of any exchange differences that relate to a hedge of a net investment in a foreign operation recognised in other comprehensive income shall not be reclassified to profit or loss on disposal or partial disposal of the foreign operation.

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

Educational notes

Examples of hedging transactions covered by paragraph 11.69 include the following:

- An entity has a recognised variable-rate debt instrument measured at amortised cost and enters into an interest rate swap, which hedges the risk of changes in the cash flows of the debt instrument due to changes in interest rates.

  If the variable-rate debt instrument is a financial liability (for example, a variable-rate loan from a bank, in which the interest rate is based on a quoted interest rate such as SONIA), variable-rate interest will be paid. Consequently, the entity would enter into a pay-fixed, receive-variable interest rate swap, with the swap referring to the same quoted observable rate as the loan (SONIA). The outcome of this will be that the entity pays interest at a fixed rate.

  If the variable-rate debt instrument is a financial asset (for example, an investment in variable-rate bonds in which the interest rate is based on a quoted interest rate such as SONIA), variable rate interest will be received. Consequently, the entity would enter into a pay-variable, receive-fixed interest rate swap, with the variable interest rate referring to the same quoted interest rate as the bonds (SONIA). The outcome of this will be that the entity receives interest income at a fixed rate.
- An entity has a firm commitment or highly probable forecast transaction to purchase (or sell) goods in a foreign currency in the future. The entity may wish to enter into a foreign currency swap or foreign currency forward exchange contract that will lock in a particular exchange rate between its functional currency and the foreign currency, instead of simply making the purchase (or sale) at the spot exchange rate on the date of the transaction. In other words, the entity knows in advance what amount it will pay (or will receive) in its own functional currency on that future date.
- An entity has a firm commitment or highly probable forecast transaction to purchase (or sell) a commodity. An entity may wish to enter into a commodity forward contract with another party, which, by net settling, will have the effect of locking in a particular price for the purchase (or sale) of the commodity when combined with making the purchase (or sale) at the spot price of the commodity on the date of the transaction. In other words, the entity knows in advance what net amount it will pay (or will receive) on that future date.

The examples of hedges covered by paragraph 11.69 are accounted for as follows:

The hedged item

Hedge accounting applying paragraph 11.69 has no impact on the 'normal'[7] accounting for the hedged item. Paragraph 11.69 affects only the accounting for the hedging instrument. Consequently, the hedged item will be accounted for as required in the Standard, regardless of whether it is included in a designated hedging relationship.

7 The recognition and measurement requirements that would apply in accordance with the Standard without the existence of paragraph 11.69.

The hedging instrument

The hedging instruments permitted to be used in Part II of Section 11 are derivatives. For that reason, Part II of Section 11 would normally require them to be accounted for at fair value, with gains or losses recognised in profit or loss in the period in which the change in fair value occurs. When applying hedge accounting applying paragraph 11.69, the instruments are still accounted for at fair value but the gain or loss on the hedging instrument is divided into two amounts: (i) the amount that was effective in hedging the hedged risk is recognised in other comprehensive income (OCI); and (ii) the balance is recognised in profit or loss.

Hedge effectiveness

If an entity applies hedge accounting applying paragraph 11.69 to a hedging relationship, the portion of the change in the fair value of the hedging instrument that is determined to be an effective hedge is recognised in OCI. The portion of the hedging instrument that is considered to be ineffective is the excess of the fair value of the hedging instrument; over the change in the fair value of the expected cash flows on the hedged item, attributable to the hedged risk. The result is recognised in profit or loss.

Reclassification of the hedging gain or loss

In accordance with paragraph 11.69, the gain or loss on the hedging instrument that was recognised in OCI is reclassified to profit or loss when:

- the hedged item is recognised in profit or loss (for example, when the highly probable forecast transaction, or transaction under a firm commitment, affects profit or loss), or
- the hedging relationship ends.

A forecast transaction or transaction under a firm commitment does not always affect profit or loss on the transaction date. For example, a transaction that involves the purchase of an item of property, plant or equipment will affect profit or loss because the item is depreciated and/or when it is resold. If the transaction is the sale of inventory, the transaction will affect profit or loss on the date the sale meets the requirements to be recognised under Section 23 *Revenue from Contracts with Customers*.

If the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost, the amount of the gain or loss on the interest rate swap that was recognised in OCI will equate to the accrual of the net cash settlement for that accounting period. Paragraph 11.70 explicitly requires this amount to be recognised in profit or loss.

Net investment in a foreign operation

A hedge of a net investment in a foreign operation is slightly different to the other hedges listed in paragraph 11.69. The hedges in paragraphs 11.69 (a)–(c) are hedges of the variability in the cash flows from a hedged item due to a particular risk. A hedge of a net investment (paragraph 11.69(d)) is not a hedge of cash flows. It is instead a hedge of the changes in the reporting entity's share of the net assets of a foreign operation that are due to foreign exchange risk arising on translation of those net assets into the parent's functional currency in order to incorporate the net assets into the parent's financial statements. However, the requirements for a hedge of a net investment in a foreign operation are in the same paragraphs as the hedges in paragraph 11.69 (a)–(c) because of the similarity in accounting treatment.

Consequently, for a hedge of a net investment, paragraph 11.69 is applied as follows:

- The entity recognises in OCI the portion of the change in the fair value of the hedging instrument, foreign currency swap or foreign currency forward exchange contract, that was effective in offsetting the change in the reporting entity's net investment in a foreign operation due to foreign exchange risk; and
- The entity recognises in profit or loss any excess of the fair value of the hedging instrument over the change in the reporting entity's net investment in the foreign operation due to foreign exchange risk.

Applying paragraph 11.69, even if the hedging relationship ends, any cumulative hedging gain or loss recognised in OCI is not reclassified to profit or loss. The gain or loss is not recognised even when the entity disposes of the foreign operation.

Examples—hedge risks covered by paragraph 11.69

Ex 139 On 1 January 20X4 an SME took out a three-year variable-rate loan from a bank for CU50,000. To maintain regular cash outflows, the SME decided to enter into an interest rate swap with an external party on the same date, to effectively convert the loan from a variable rate to a fixed rate so that interest is payable at the same amount each year. In addition:

- **The variable rate on the loan is SONIA plus 100 basis points and this is annually reset. The loan is at the market rate of interest for a loan to the SME. Interest is paid annually on 31 December based on SONIA at the start of the year. Initial SONIA is 3.25%.**
- **The swap is a three-year pay 3.25% fixed, receive SONIA interest rate swap with a nominal value of CU50,000. The floating leg of the swap is annually reset. Interest is payable at the end of the year based on SONIA at the start of the year. The interest rate swap is on-market at inception, has a fair value of zero and has no prepayment, early termination or extension features. The credit rating of the SME and of the external party remain the same throughout the three-year period and hence the changes in the fair value of the swap are due only to changes in interest risk; that is, the change in the fair value of the swap is fully effective in offsetting the change in the expected cash flows of the hedged item that is due to interest rate risk.**

	1 January 20X4 *CU*	*31 December 20X5* *CU*	*31 December 20X6* *CU*
Fair value (asset/(liability)) of interest rate swap[8]	–	250	(75)

The SME does not wish to apply hedge accounting to this transaction. Consequently, the SME neither designates nor documents the hedging relationship.

Assume SONIA is 3.5% on 1 January 20X5 and 3.1% on 1 January 20X6.

8 The figures in the table have not been calculated accurately and are for illustration purposes only. The effects of the time value of money have been ignored.

1 January 20X4

The journal entries on initial recognition are as follows:

Dr	Asset: financial asset—cash	CU50,000	
	Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash.

The loan is measured initially at CU50,000, its transaction price.

Because the swap has a fair value of zero on 1 January 20X4, no entries are required on initial recognition.

31 December 20X4

The journal entries, with SONIA at 3.25% on 1 January 20X4, are as follows on 31 December 20X4:

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,125[(a)]	
	Cr Asset: financial asset—cash		CU2,125

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr	Asset: financial asset—swap	CU250	
	Cr Income: profit or loss—change in fair value of swap		CU250

To record the change in fair value of interest rate swap.

Swap—periodic net cash settlement

Dr	Asset: financial asset—swap	CU0[(b)]	
	Cr Asset: financial asset—cash		CU0

To record the cash flow under the swap agreement.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.25% + 1%) = CU2,125.

(b) Net payment under swap = CU50,000 × (3.25% – SONIA) = CU50,000 × (3.25% – 3.25%) = CU0. In accordance with the terms of the swap, payments are calculated and paid at the end of each year but based on SONIA at the start of the year; the payment at 31 December 20X4 will therefore always be zero regardless of the level of SONIA at 31 December 20X4.

At 31 December 20X4 the carrying amount of the loan is a liability of CU50,000 and the swap is an asset of CU250. The loan continues to be recorded at CU50,000 applying the amortised cost method (see Part I of this section for more explanation).

31 December 20X5

The journal entries, with SONIA at 3.5% on 1 January 20X5, are as follows on 31 December 20X5:

Loan—interest

Dr Expense: profit or loss—finance costs	CU2,250	
Cr Asset: financial asset—cash		CU2,250[(a)]

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr Expense: profit or loss—change in fair value of swap	CU200	
Cr Asset: financial asset—swap		CU200[(b)]

To record the change in fair value of interest rate swap

Swap—periodic net cash settlement

Dr Asset: financial asset—cash	CU125[(c)]	
Cr Asset: financial asset—swap		CU50
Cr Liability: financial liability—swap		CU75

To record the cash flow under the swap agreement.The journal entry is split because the swap changes from an asset to a liability.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.5% + 1%) = CU2,250.

(b) Change in fair value of swap = CU(75) – (CU250 – CU125) = CU200.

(c) Net receipt under swap = CU50,000 × (SONIA – 3.25%) = CU50,000 × (3.5% – 3.25%) = CU125.

At 31 December 20X5, the carrying amount of the loan is a liability of CU50,000 and the swap is a liability of CU75.

31 December 20X6

The journal entries, with SONIA at 3.1% on 1 January 20X6, are as follows on 31 December 20X6:

Loan—interest

Dr Expense: profit or loss—finance costs	CU2,050[(a)]	
Cr Asset: financial asset—cash		CU2,050

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr Expense: profit or loss—change in fair value of swap	CU0[(b)]	
Cr Liability: financial liability—swap		CU0

To record the change in fair value of interest rate swap.

Swap—periodic net cash settlement

Dr	Liability: financial liability—swap	CU75[(c)]	
	Cr Asset: financial asset—cash		CU75

To record the cash flow under the swap agreement.

Loan—settlement

Dr	Liability: financial liability—loan	CU50,000	
	Cr Asset: financial asset—cash		CU50,000

To record the repayment of principal under loan agreement.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.1% + 1%) = CU2,050.

(b) Change in fair value of swap = CU0 – (CU(75) + CU75) = CU0.

(c) Net payment under swap = CU50,000 × (3.25% – SONIA) = CU50,000 × (3.25% – 3.1%) = CU75.

At 31 December 20X6, the loan and the swap have both reached maturity; hence, after settlement of the loan, both have a carrying amount of nil.

This example shows the result of the SME taking out an interest rate swap of the variable interest rate risk of its loan as an economic hedge, but not applying hedge accounting.

The journal entries show that the swap has the effect of transforming the loan into a fixed rate loan. Each year the SME effectively pays annual interest of CU2,125—it effectively pays interest at the fixed rate of 4.25% of the principal amount—the total of the interest payable on the loan plus (or minus) the cash payment (or receipt) under the swap. The SME pays interest at the rate of SONIA plus 1% on the loan and pays 3.25% interest under the swap. The SME receives interest at the rate of SONIA under the swap (= SONIA + 1% + 3.25% – SONIA = 4.25%).

Summary—entries recognised in profit or loss when not applying hedge accounting

	20X4	20X5	20X6	Total
Loan interest payable	(2,125)	(2,250)	(2,050)	(6,425)
Swap—payment	–	125	(75)	50
Swap—residual change in fair value	250	(325)	75	–
	(1,875)	(2,450)	(2,050)	(6,375)

The overall effect on profit or loss of the swap is a gain of CU50, which is equal to the sum of the net cash settlements in each of the three years. However, the swap causes volatility in profits during each individual year because of fluctuations in its fair value during the three-year period.

Ex 140 The facts are the same as in Example 139. However, in this example, the SME wishes to designate a hedging relationship between the interest rate swap and the SONIA interest rate risk of the loan in such a way as to qualify for hedge accounting. Consequently, on 1 January 20X4, the entity designates and documents the hedging relationship applying paragraph 11.62(a).

The interest rate swap is expected to be highly effective, because the principal terms of the loan and the swap match. The SME may, therefore, designate a hedging relationship between the interest rate swap and the SONIA interest rate risk of the loan and, because the SME complies with all the conditions in paragraph 11.62, apply hedge accounting.

1 January 20X4

The journal entries on initial recognition are as follows:

Dr	Asset: financial asset—cash	CU50,000	
	Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash.

The loan is measured initially at CU50,000, its transaction price. Because the swap has a fair value of zero on 1 January 20X4, no entries are required on initial recognition.

31 December 20X4

The journal entries on 31 December 20X4 are as follows (SONIA = 3.25% on 1 January 20X4):

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,125[(a)]	
	Cr Asset: financial asset—cash		CU2,125

To record the finance costs for the period and the payment of coupon interest.

Dr	Asset: financial asset—swap	CU250	
	Cr Income: OCI-change in fair value (hedging instrument)		CU250

To record the change in fair value of interest rate swap.

Swap—accrual of periodic net cash settlement

Dr	Income: OCI-change in fair value (hedging instrument)	CU0[(b)]	
	Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU0

To record the accrued net cash settlement of interest rate swap.

Swap—periodic net cash settlement

Dr Asset: financial asset—cash	CU0[b]	
Cr Asset: financial asset—swap		CU0

To record the cash flow under the swap agreement.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.25% + 1%) = CU2,125.

(b) Net payment under swap = CU50,000 × (3.25% – SONIA) = CU50,000 × (3.25% – 3.25%) = CU0. In accordance with the terms of the swap, payments are calculated and paid at the end of each year but based on SONIA at the start of the year; the payment at 31 December 20X4 will therefore always be zero regardless of the level of SONIA at 31 December 20X4.

At 31 December 20X4, the carrying amount of the loan is a liability of CU50,000; the swap is an asset of CU250.

31 December 20X5

The journal entries, with SONIA at 3.5% on 1 January 20X5, are as follows on 31 December 20X5:

Loan—interest

Dr Expense: profit or loss—finance costs	CU2,250[a]	
Cr Asset: financial asset—cash		CU2,250

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr Expense: OCI-change in fair value (hedging instrument)	CU200	
Cr Asset: financial asset—swap		CU200[b]

To record the change in fair value of interest rate swap.

Swap—accrual of periodic net cash settlement

Dr Expense: OCI-change in fair value (hedging instrument)	CU125[c]	
Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU125

To record the accrued net cash settlement of interest rate swap.

Swap—periodic net cash settlement

Dr Asset: financial asset—cash	CU125[c]	
Cr Asset: financial asset—swap		CU50
Cr Liability: financial liability—swap		CU75

To record the cash flow under the swap agreement.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.5% + 1%) = CU2,250.

(b) Change in fair value of swap = CU(75) – (CU250 – CU125) = CU200.

(c) Net receipt under swap = CU50,000 × (SONIA – 3.25%) = CU50,000 × (3.5% – 3.25%) = CU125.

At 31 December 20X5, the carrying amount of the loan is a liability of CU50,000; the swap is a liability of CU75.

31 December 20X6

The journal entries, with SONIA at 3.1% on 1 January 20X6, are as follows on 31 December 20X6:

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,050[(a)]	
	Cr Asset: financial asset—cash		CU2,050

To record the finance costs for the period and the payment of coupon interest.

Swap—change in fair value

Dr	Liability: financial liability—swap	CU0[(b)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU0

To record the change in fair value of interest rate swap.

Swap—accrual of periodic net cash settlement

Dr	Expense: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)	CU75[(c)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU75

To record the accrued net cash settlement of interest rate swap.

Swap—periodic net cash settlement

Dr	Liability: financial liability—swap	CU75[(c)]	
	Cr Asset: financial asset—cash		CU75

To record the cash flow under the swap agreement.

Loan—settlement

Dr	Liability: financial liability—loan	CU50,000	
	Cr Asset: financial asset—cash		CU50,000

To record the repayment of principal under loan agreement.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.1% + 1%) = CU2,050.
(b) Change in fair value of swap = CU0 – (CU(75) + CU75) = CU0.
(c) Net payment under swap = CU50,000 × (3.25% – SONIA) = CU50,000 × (3.25% – 3.1%) = CU75.

At 31 December 20X6 the loan and the swap have both reached maturity; hence, after settlement of the loan, both have a carrying amount of nil.

This example shows the result of the SME taking out an interest rate swap as a hedge of the variable interest rate risk of its loan and applying hedge accounting.

As a result of entering into the interest rate swap, each year, the SME effectively pays interest at 4.25% of the principal amount.

Summary: entries recognised in profit or loss when applying hedge accounting

	20X4	20X5	20X6	Total
Loan interest payable	(2,125)	(2,250)	(2,050)	(6,425)
Swap—reclassification*	–	125	(75)	50
	(2,125)	(2,125)	(2,125)	6,375

* Equals the accrual for the net cash (payment)/receipt.

Instead of recognising the changes in the fair value of the swap in profit or loss as they occur, applying paragraphs 11.69 and 11.70, hedge accounting results in the recognition of those changes in fair value in other comprehensive income. The effect of hedge accounting is, therefore, a reduction in the volatility of annual profit or loss during a hedging relationship. Over the three-year period of the loan, the fair value of the swap could fluctuate significantly if SONIA is volatile, changing from an asset in one period to a liability in another period. In this case, recognising the change in fair value in other comprehensive income avoids significant debits and credits from being recognised in profit or loss during the three-year period. Instead, the volatility only affects the total comprehensive income figure. Because the interest rate swap has a fair value of nil on initial recognition and maturity, the overall effect on other comprehensive income is nil.

Summary: entries recognised in other comprehensive income when applying hedge accounting

	20X4	20X5	20X6	Total
Swap—change in fair value	(250)	200	–	(50)
Swap—reclassification*	–	125	(75)	50
	(250)	325	(75)	–

* Equals the accrual for the net cash (payment)/receipt.

In effect, a part of the hedging gain has been reclassified from OCI to profit or loss each year to match the time of when the effect of the risk being hedged was recognised in profit or loss. If the annual payments under the swap had been made one day later, that is, on 1 January rather than on 31 December, the fair value of the swap would be as follows:

	1 January 20X4 CU	31 December 20X4 CU	31 December 20X5 CU	31 December 20X6 CU
Fair value of interest rate swap	–	250	50	(75)

The journal entries at 31 December 20X5 and on 1 January 20X6, assuming that the annual payments under the swap and the annual interest payments and capital repayment under the loan had been made on 1 January rather than on 31 December, would be as follows:

31 December 20X5 (SONIA = 3.5% on 1 January 20X5)

Loan—interest

Dr Expense: profit or loss—finance costs	CU2,250[(a)]	
Cr Liability: financial liability—loan		CU2,250

To record the finance costs for the period.

Swap—change in fair value

Dr Expense: OCI-change in fair value (hedging instrument)	CU200	
Cr Asset: financial asset—swap		CU200[(b)]

To record the change in fair value of interest rate swap.

Swap—accrual of periodic net cash settlement

Dr Expense: OCI-change in fair value (hedging instrument)	CU125	
Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU125[(c)]

To record the accrued net cash settlement of interest rate swap.

(a) CU50,000 × (SONIA + 1%) = CU50,000 × (3.5% + 1%) = CU2,250.

(b) Change in fair value of swap = CU50 – CU250 = CU(200).

(c) Accrual for net receipt under swap = CU50,000 × (SONIA – 3.25%) = CU50,000 × (3.5% – 3.25%) = CU125.

At 31 December 20X5 the carrying amount of the loan is a liability of CU52,250 and the swap is an asset of CU50.

1 January 20X6

Loan—interest cash payment

Dr	Liability: financial liability—loan	CU2,250	
	Cr Asset: financial asset—cash		CU2,250

To record the payment of coupon interest.

Swap—periodic net cash settlement

Dr	Asset: financial asset—cash	CU125	
	Cr Asset/Liability: financial asset/liability—swap		CU125

To record the cash flow under the swap agreement.

Ex 141 **On 1 November 20X5 a tin mining SME, whose functional currency is the CU, forecasts that it will sell 500 tonnes of tin to its biggest customer in early February 20X6 at the spot price at the date that the transaction occurs. The sale is considered to be highly probable.**

The SME's management expects the price of tin to fall by early February 20X6. Consequently, to hedge the tin price risk in the highly probable forecast sale, the SME enters into a forward contract with an external party to sell 500 tonnes of tin on 1 February 20X6 for CU11,440,000. The forward contract permits the SME to net settle in cash based on the price specified in the contract and the fair value of the tin, calculated using the spot price, at the end of the contract. The SME intends to net settle the forward contract.

Because the contract is to be net settled, it is within the scope of Part II of Section 11. The forward contract has no prepayment, early termination or extension features. The SME's reporting period ends 31 December.

At inception of the hedge, the forward contract is initiated at current market rates and its initial fair value is nil. The SME expects the forward contract to be highly effective in offsetting changes in the spot price of tin.

The following information relates to the fair value of tin and the forward contract:

	1 November 20X5 CU	*31 December 20X5 CU*	*1 February 20X6 CU*
Market value of tin per tonne	22,500	21,000	20,000
Fair value of the 500 tonnes of tin	11,250,000	10,500,000	10,000,000
Change in fair value of expected cash flows from the sale assuming the spot price remains unaltered for the remainder of the contract (ignoring time value of money)	–	(750,000)	(500,000)
Price in forward contract (or notional forward contract) if taken out on 31 December 20X5 for delivery of 500 tonnes of tin on 1 February 20X6		10,558,000	n/a
Fair value of forward contract (ignoring time value of money)	–	882,000	1,440,000
Change in fair value of forward contract		882,000	558,000

The SME sells 500 tonnes of tin to the customer for CU10,000,000 on 1 February 20X6.

Management does not wish to apply hedge accounting to this transaction. Consequently, management neither designates nor documents the hedging relationship.

The journal entries are as follows:

1 November 20X5

Because the forward contract has a fair value of zero on 1 November 20X5, no entries are required on initial recognition.

31 December 20X5

Forward contract—change in fair value

Dr Asset: financial asset—forward contract	CU882,000	
Cr Income: profit or loss—change in fair value of forward contract		CU882,000

To record the change in fair value of forward contract.

1 February 20X6

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU558,000	
Cr	Income: profit or loss—change in fair value of forward contract		CU558,000

To record the change in fair value of forward contract.

Forward contract—net settlement

Dr	Asset: financial asset—cash	CU1,440,000[(a)]	
Cr	Asset: financial asset—forward contract		CU1,440,000

To record the cash flow on termination of the forward contract.

Sale of tin

Dr	Asset: financial asset—cash	CU10,000,000	
Cr	Income: profit or loss—revenue		CU10,000,000

To record the sale of tin to customer and receipt of cash.

(a) The cash payment of CU1,440,000 equals CU11,440,000, as specified in the forward exchange contract, minus CU10,000,000, the fair value of the tin at the end of the forward contract.

Ex 142 The facts are the same as in Example 141. However, in this example, the SME wishes to designate a hedging relationship between the commodity-based forward contract and the price risk of the tin in the highly probable forecast sale in such a way so as to qualify for hedge accounting. Consequently, on 1 November 20X5 the SME designates and documents the hedging relationship applying paragraph 11.62(a).

The hedging relationship is expected to be highly effective, because the principal terms of the highly probable forecast transaction and the forward contract match. The SME may, therefore, designate a hedging relationship between the forward contract and the tin price risk in the highly probable forecast transaction and can apply hedge accounting, because the SME complies with all the conditions in paragraph 11.62.

The journal entries are as follows:

1 November 20X5

Because the forward contract has a fair value of zero on 1 November 20X5, no entries are required on initial recognition.

31 December 20X5

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU882,000	
	Cr Income: OCI-change in fair value (hedging instrument)[9]		CU750,000
	Cr Income: profit or loss—ineffective portion of hedging instrument[(a)]		CU132,000

To record the change in fair value of forward contract.

1 February 20X6

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU558,000	
	Cr Income: OCI-change in fair value (hedging instrument)		CU500,000
	Cr Income: profit or loss—ineffective portion of hedging instrument[(a)]		CU58,000

To record the change in fair value of forward contract.

Forward contract—net settlement

Dr	Asset: financial asset—cash	CU1,440,000[(b)]	
	Cr Asset: financial asset—forward contract		CU1,440,000

To record the cash flow on termination of the forward contract.

Sale of tin

Dr	Asset: financial asset—cash	CU10,000,000	
	Cr Income: profit or loss—revenue		CU10,000,000

To record the sale of tin to customer and receipt of cash.

Reclassification from other comprehensive income to profit or loss[10]

Dr	Income: OCI-change in fair value (hedging instrument)	CU1,250,000	
	Cr Income: Profit or loss—fair value income (hedging instrument – resale of tin)		CU1,250,000

To record the reclassification of hedging gain from OCI to profit or loss.

(a) In accordance with paragraph 11.69, the ineffective portion of the hedging instrument is the excess of the fair value of the hedging instrument (CU882,000 at 31 December 20X5) over the change in the fair value of the expected cash flows of the hedged item (CU750,000 at 31 December 20X5).

(b) The cash payment of CU1,440,000 equals CU11,440,000, as specified in the forward exchange contract, minus CU10,000,000, the fair value of the tin at the end of the forward contract.

9 This hedge is a hedge of commodity price risk in a highly probable forecast sale, not a hedge of commodity price risk of inventory. Accordingly, the requirements in paragraph 11.69 apply, not paragraph 11.65.

10 Conceptually, there is neither income nor expense because there has been no change in the SME's assets or liabilities. This journal entry is moving, from OCI to profit or loss, income that was recognised previously.

The income attributable to the hedging instrument recognised in OCI is reclassified from OCI to profit or loss on 1 February 20X6 (that is, when the hedged item is recognised in profit or loss or when the hedging relationship ends—in this case both events are on the same date).

The effect of hedge accounting does not change total profits over time, but it reduces the volatility of reported annual profits during the period that the hedging relationship exists. If the price risk was hedged over a longer period, for example 10 years, and during this period, tin prices were volatile, the fair value of the forward contract would fluctuate significantly, possibly even changing from an asset in one period to a liability in another period. Recognising the effective portion of the gains and losses in OCI, applying hedge accounting, avoids volatility in profit or loss until the conclusion of the hedging relationship.

11.71 The entity shall discontinue prospectively the hedge accounting specified in paragraph 11.69 if:

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

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 11.62;

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

(d) the entity revokes the designation.

If the forecast transaction is no longer expected to take place or if the hedged debt instrument measured at amortised cost is derecognised, any gain or loss on the hedging instrument that was recognised in other comprehensive income shall be reclassified to profit or loss.

Example—discontinued hedge accounting

Ex 143 The facts are the same as in Example 142. However, in this example, because the inventory is damaged in a fire at the storage facility on 8 January 20X6, the forecast sale to the customer does not take place. The SME is not sure when the tin will be in a condition to be suitable for sale.

On 8 January 20X6 the fair value of the forward contract is CU985,000 and the fair value of 500 tonnes of tin is CU10,400,000.

On 1 January 20X6 the forecast transaction is considered highly probable. However, because of the fire (a change in circumstances), this assessment must be repeated on 8 January 20X6. On reassessment, the forecast transaction is no longer considered to be highly probable, even though a sale of part of the cleaned-up tin is possible later in the year.

Consequently, on 8 January 20X6 hedge accounting must be discontinued as illustrated in the following journal entries.

31 December 20X5 (same as Example 142)

Forward contract—change in fair value

Dr	Asset: financial asset–forward contract	CU882,000	
	Cr Income: OCI-change in fair value (hedging instrument)		CU750,000
	Cr Income: profit or loss—ineffective portion of hedging instrument		CU132,000

To record the change in fair value of forward contract.

8 January 20X6

Forward contract—change in fair value during period hedge is effective (from 1 January 20X6 to 8 January 20X6)

Dr	Asset: financial asset—forward contract	CU103,000[(a)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU100,000[(b)]
	Cr Income: profit or loss—ineffective portion of hedging instrument		CU3,000

To record the change in fair value of forward contract.

Transfer from other comprehensive income to profit or loss on 8 January 20X6

Dr	Income: OCI—change in fair value (hedging instrument)	CU850,000	
	Cr Profit or loss—fair value income (hedging instrument—re expected sale of tin)		CU850,000

To record the reclassification of hedging gain from OCI to profit or loss on termination of the hedging relationship.

1 February 20X6

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU455,000[(c)]	
	Cr Income: profit or loss—change in fair value of forward contract		CU455,000

To record the change in fair value of forward contract.

Forward contract—net settlement

Dr	Asset: financial asset—cash	CU1,440,000	
	Cr Asset: financial asset—forward contract		CU1,440,000

To record the cash flow on termination of the forward contract.

(a) CU985,000 – CU882,000 = CU103,000.

(b) CU10,500,000 – CU10,400,000 = CU100,000.

(c) CU558,000, change in fair value from 1 January to 1 February, minus CU103,000, change in fair value from 1 January to 8 January, recognised on 8 January = CU455,000 change in fair value from 9 January to 1 February. Because hedge accounting has been discontinued from 8 January 20X6, all of the change in fair value is recognised directly in profit or loss.

Disclosures

11.72 An entity applying Part II of Section 11 shall make all of the disclosures required in Part I of Section 11 incorporating in those disclosures financial instruments that are within the scope of Part II of Section 11 as well as those within the scope of Part I of Section 11. In addition, if the entity uses hedge accounting, it shall make the additional disclosures in paragraphs 11.73–11.75.

Educational notes

Module 11 on Part I of Section 11 illustrates and discusses the disclosures required under Part I of Section 11. The examples and notes in Module 11 on Part I of Section 11 focus on financial instruments within the scope of Part I of Section 11. Paragraph 11.72 requires the disclosure requirements of Part I of Section 11 be applied to financial instruments within the scope of Part II of Section 11. Examples 144 and 145 illustrate paragraph 11.40 (summary of material accounting policies for financial instruments) disclosures for two of the more common financial instruments within the scope of Part II of Section 11. In addition to illustrating some of the disclosures required by Part I of Section 11, Example 145 illustrates some of the disclosures required by Part II of Section 11.

Example 144 is for reference only and should not be used by entities as a template. Entities should explain their own specific facts and circumstances and provide information relevant to users.

Example—general disclosures

Ex 144 Extract from notes to SME A's financial statements for the year ended 31 December 20X4[11]

Note 2: Accounting policies (extract)
Forward contracts and interest rate swaps
Foreign currency forward exchange contracts and interest rate swaps are used to manage exposure to foreign exchange and interest rate risk. The forward contracts and interest rate swaps are initially recognised at fair value, which is zero if the contract is entered into at market prices or rates. Any transaction costs are recognised in profit or loss immediately. Such contracts are subsequently measured at fair value, with changes in fair value recognised in profit or loss during the period, unless the instrument is designated as, and is expected to be effective as, a hedging instrument, in which case, the policy for hedge accounting is applied.
The fair value of foreign currency forward contracts is calculated by comparing the contracted rates with the current forward exchange rates for contracts with similar maturity profiles and discounting the difference in expected cash flows to reflect the time value of money. The fair value of interest rate swaps is determined by reference to market values for similar instruments and specific valuations performed by counterparties at the date of the statement of financial position.

11 Management should tailor disclosures to an entity's own particular facts and circumstances to enhance this disclosure. SME A's policy for hedge accounting is illustrated in Example 144.

Note 20: Derivative financial instruments (extract)
Foreign currency forward exchange contracts The fair value of foreign currency forward contracts is calculated by comparing the contracted rates with the current forward exchange rates for contracts with similar maturity profiles and, using SONIA, discounting the difference in expected cash flows to reflect the time value of money. *Interest rate swaps* The fair value of interest rate swaps is determined by reference to market values for similar instruments and specific valuations performed by counterparties at the date of the statement of financial position.

11.73 An entity shall disclose the following separately for hedges of each of the four types of risks described in paragraph 11.63:

(a) a description of the hedge;

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

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

Educational notes

In the absence of hedge accounting as the Standard permits, gains and losses on hedging instruments or hedged items would be recognised in different accounting periods.

Hedge accounting disclosures are necessary for the user to understand the nature of an entity's hedging relationships and the effect those hedging relationships have had on the entity's performance during the current and prior periods; the disclosures also show the effects the entity expects in future periods.

Example—hedge accounting disclosures

Ex 145 Extract from notes to SME A's financial statements for the year ended 31 December 20X4

Note 2: Accounting policies (extract)

Hedge accounting

Forward contracts and interest rate swaps are used to reduce currency risk and interest rate risk. When the contracts or swaps are expected to be highly effective in offsetting the designated risk, hedge accounting is applied to the transaction. Hedge accounting permits the gain or loss on the hedging instrument or on the hedged item, as appropriate, to be recognised in profit or loss at the same time.

The entity uses the following types of hedging instruments:

- Interest rate swaps. The swaps are used to offset variable interest rate risk in bank loans by exchanging variable-rate interest for fixed-rate interest. When the swap and the loan qualify for hedge accounting, the portion of the change in the fair value of the swap that is effective in offsetting the changes in interest payments due to changes in market interest rates is recognised in other comprehensive income. The balance, if any, of the change in fair value of the swap is recognised in profit or loss. An amount equal to the periodic net cash settlements accruing under the swap for the financial period is reclassified to profit or loss in that financial period. The variable rate interest payable on the loan being hedged is also recognised in profit or loss. The resulting effect is that fixed-rate interest is recognised in profit or loss in each period in which the hedge is effective. When the loan is derecognised, for example on early settlement, any cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income is reclassified to profit or loss.
- Foreign currency forward exchange contracts. These forward contracts are used to offset foreign exchange risk in firm commitments to purchase specialised point-of-sale computer systems and computer equipment from overseas suppliers when the purchase price is denominated in a foreign currency. Such a forward contract is measured at fair value at each reporting date. The portion of the change in the fair value of the forward contract that is effective in offsetting the change in the purchase price due to movements in exchange rates is recognised in other comprehensive income. Any excess of the change in the fair value of the forward contract over the change in the purchase price due to movements in exchange rates is recognised in profit or loss. The cumulative hedging gain or loss that has been recognised in other comprehensive income is reclassified to profit or loss when the computer system is recognised as an expense, usually as it is depreciated.

Note 20: Derivative financial instruments (extract)		
	20X4 CU	20X3 CU
Fair values of derivative instruments held and designated as hedging instruments:		
Interest rate swaps	9,500	(5,000)
Foreign currency forward exchange contracts	7,050	3,200

11.74 If an entity uses hedge accounting for a hedge of fixed interest rate risk or commodity price risk of a commodity held (paragraphs 11.65–11.68) it shall disclose the following:

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

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

Example—disclosures using hedge accounting (fixed interest rate risk or commodity price risk)

Ex 146 Extract from notes to SME A's financial statements for the year ended 31 December 20X4

Note 10: Profit for the year (extract)		
	20X4 CU	20X3 CU
Profit for the year is stated after recognising:		
Gains/(losses) arising on forward contracts for wheat in a designated hedge accounting relationship	35,000	(28,000)
Gains/(losses) arising on adjustment to inventory of wheat in a designated hedge accounting relationship	(36,000)	28,000

11.75 If an entity uses hedge accounting for a hedge of variable interest rate risk, foreign exchange risk, commodity price risk in a firm commitment or highly probable forecast transaction or a net investment in a foreign operation (paragraphs 11.69–11.71) it shall disclose the following:

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

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

(c) the amount of the change in fair value of the hedging instrument that was recognised in other comprehensive income during the period (paragraph 11.69);

(d) the amount that was reclassified to profit or loss for the period (paragraphs 11.69 and 11.71); and

(e) the amount of any excess of the cumulative change in fair value of the hedging instrument over the cumulative change in the fair value of the expected cash flows that was recognised in profit or loss for the period (paragraph 11.69).

Educational notes

These disclosures are required in respect of hedge accounting applying paragraphs 11.69–11.71; that is, they are in respect of 'cash flow hedges'.

In Example 147, the disclosures required by paragraph 11.75(c)–(e) have been shown in the statement of comprehensive income rather than in Note 20. Actuarial gains and losses are shown in shading because an entity is not specifically required to disclose them, applying Section 11. The gains and losses are included to show what else may appear in other comprehensive income.

Example—disclosures where hedge accounting is used for hedges of variable interest rate risk, foreign exchange risk and/or commodity price risk in a highly probable forecast transaction

Ex 147 Extract from SME A's statement of comprehensive income for the year ended 31 December 20X4

	Notes	*20X4 CU*	*20X3 CU*
Profit for the year		**1,121,250**	**865,500**
Other comprehensive income:			
Items that will not be reclassified to profit or loss:			
Actuarial gains (losses) on defined benefit pension plans		(67)	13
		(67)	**13**
Items that may be reclassified subsequently to profit or loss:			
Change in fair value of hedging instruments net of reclassification[12]	20	(2,319)	(1,506)
		(2,319)	**(1,506)**
Other comprehensive income for the year		**(2,386)**	**(1,493)**
Income tax related to items in other comprehensive income		597	373
Total comprehensive income for the year		**1,119,461**	**864,380**

12 This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

Extract from notes to SME A's financial statements for the year ended 31 December 20X4

Note 20: Derivative financial instruments (extract)

The entity has entered into a number of interest rate swaps to achieve a fixed interest rate on its variable-rate interest exposure that arises from bank loans. One of the swaps has three years still to run while all the other swaps have two years to run.

The entity has a number of foreign currency forward contracts to hedge changes in the price of specialised point-of-sale computer systems and computer equipment as a result of foreign exchange rate movements. It is highly probable that the entity will purchase the equipment in July 20X5 from overseas suppliers. The point of sale computer systems and computer equipment will be depreciated over their useful lives of five years.

In 20X4, the entity abandoned a highly probable forecast purchase of yet-to-be-manufactured computer equipment following the liquidation of the supplier when its plant was destroyed by a tsunami. Consequently, the purchase transaction never took place and all accumulated hedging gains on the forward contract were reclassified to profit or loss in 20X4.

The entity chooses an aggregated presentation of gains and losses on hedging instruments recognised in other comprehensive income. The amounts for reclassification adjustments and current year gain (loss) are as follows:

	20X4 *CU*	*20X3* *CU*
Gains/(losses) arising during the year	251	(4,510)
Transfers to profit or loss of (gains)/losses on hedges previously recognised in other comprehensive income	(1,840)	3,004
Transfer to profit or loss of gains on a forward exchange contract that is no longer used as a hedge	(730)	–
Change in fair value of hedging instruments net of reclassification	**(2,319)**	**(1,506)**

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the 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 Standard require disclosure of information about particular judgements and estimation uncertainties.

Basic financial instruments

Assessing whether the contractual terms of the instrument give rise on specified dates to cash flows that are solely payments of principal and interest on the outstanding principal amount may require judgement. Judgement may be required to determine if the contractual terms introduce risks or volatility that is not consistent with a basic lending arrangement.

Initial measurement

Assessing whether a transaction constitutes a financing arrangement 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 credit transactions. 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 constitute a financing arrangement.

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 require judgement. Transaction costs are only those incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the 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 (such as arrangement fees or legal fees) or internal administrative costs.

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.

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 in estimating 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. Determining 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. Because 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 an approximation in some cases.

Judgement needs to be applied before concluding that the fair value of some equity instruments cannot be measured reliably without undue cost or effort. Such instruments are measured at cost less impairment.

Performing an impairment test for equity instruments measured at cost requires significant judgement. An entity only measures an instrument at cost if the fair value cannot be measured reliably; consequently, 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 difficult to determine. The Standard does not permit the impairment to be omitted on the grounds that the measurement is difficult; consequently, the entity must use judgement to estimate the impairment.

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. Judgement is sometimes required in determining whether to derecognise a financial liability, when assessing whether the terms of the financial instruments exchanged are substantially different and whether there is a substantial modification of the terms.

Scope of Part II of Section 11

Judgement may need to be applied in interpreting 'unrelated', as used in paragraphs 11.49(d), 11.49(f) and 11.50. In particular, assessing whether some contracts to buy, sell, lease or insure non-financial items are within the scope of Part II of Section 11 may require judgement if they contain risks partially but not completely related to common risks such as foreign exchange risk or price risk. For example, a contract to buy, sell, lease or insure a non-financial item may include a risk that is related to the price risk of a different non-financial item, but judgement is required if the price of that non-financial item nevertheless shows some correlation with the price of the non-financial item in the contract.

Hedging

Management must apply judgement when assessing whether it expects a particular hedging instrument to be highly effective in offsetting a specific designated risk, particularly if the principal terms of the hedging instrument and the hedged item relating to the particular risk are not perfectly matched.

Part II of Section 11 permits hedge accounting to be applied for forecast transactions if they are considered to be highly probable to occur. Judgement needs to be applied in determining how likely it is that a transaction will occur.

TRANSITION REQUIREMENTS

The third edition of the *IFRS for SMEs* Accounting Standard is effective for annual reporting periods beginning on or after 1 January 2027. Early application is permitted. Changes made to Section 11 from the second edition of the Standard are summarised in pages 7–8.

Transition from IAS 39 *Financial Instruments: Recognition and Measurement*

A11 An entity that previously applied the **recognition** and measurement requirements in IAS 39 *Financial Instruments: Recognition and Measurement* shall retrospectively apply the recognition and measurement requirements in Section 11 *Financial Instruments* in accordance with Section 10. However, such an entity shall:

- (a) not recognise financial assets and liabilities derecognised in accordance with IAS 39 before the date of initial application. If the entity did not derecognise financial assets and liabilities in accordance with IAS 39 that would have been derecognised in accordance with Section 11 in a transaction before the date of initial application, the entity is permitted:
  - (i) to derecognise these financial assets and liabilities on the date of initial application; or
  - (ii) to continue to recognise these financial assets and liabilities until they are disposed of or settled.
- (b) assess whether a financial asset meets the conditions described in paragraphs 11.9–11.9ZA based on the facts and circumstances at the date of initial application. The entity shall retrospectively apply the resulting classification.
- (c) if it is impracticable to apply retrospectively the **effective interest method**, treat the fair value of the **financial asset** or the **financial liability**:
  - (i) at the end of each comparative period as the gross carrying amount of that financial asset or the amortised cost of that financial liability; and
  - (ii) at the date of initial application as the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of initial application.
- (d) prospectively apply the hedge accounting requirements in Part II of Section 11 from the date of initial application. An entity shall leave unchanged until the date of initial application its hedge accounting for hedging relationships that no longer exist at the date of initial application in accordance with the third edition of the Standard. For hedging relationships that exist at the date of initial application, the entity shall follow the hedge accounting requirements in Section 11, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions described in Section 11.

Educational notes

In the previous edition of the Standard, entities had the option to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. This option has been removed from the third edition of the Standard, meaning all entities will apply the requirements of Section 11 in accounting for financial instruments. Appendix A *Effective date and transition* sets out the transition requirements for entities that previously made use of the option to apply IAS 39.

An entity shall retrospectively apply the recognition and measurement requirements in Section 11, in accordance with Section 10 *Accounting Policies, Estimates and Errors*. For entities that previously used the option to apply IAS 39, the following exceptions apply to retrospective application:

A11(a) Derecognising financial assets and liabilities

If financial assets and financial liabilities were derecognised applying IAS 39 before the date the entity starts applying the third edition of the Standard, the entity shall not recognise those financial assets and financial liabilities. For example, if an entity derecognised a financial asset (that is, a debt instrument) in 20X5, the entity does not recognise the financial asset when it first applies the third edition of the Standard, in 20X7. If, however, financial assets and financial liabilities that would have been derecognised applying Section 11 have not been derecognised before applying the third edition of the Standard, the entity has a choice to derecognise the financial assets or financial liabilities when it first applies Section 11 or continue to recognise the financial assets and financial liabilities until they are disposed of or settled.

A11(b) Recognising financial assets based on paragraphs 11.9–11.9ZA

An entity is required to assess whether financial assets meet the requirements in paragraphs 11.9–11.9ZA based on the facts and circumstances on the date it first applies Section 11. The results of such an assessment should be applied retrospectively. For example, if an entity recognised a financial asset and on the date it first applies Section 11, the financial asset does not meet the requirements in paragraphs 11.9–11.9ZA, the financial asset should be classified as a financial asset within the scope of Part II of Section 11, rather than Part I of Section 11. The entity should retrospectively classify the financial asset as within the scope of Part II of Section 11.

A11(c) Treatment of fair value when it is impracticable to apply the effective interest method

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so (see Glossary). Paragraph A11(c) provides the treatment of fair value of a financial asset and financial liability if it is impracticable to apply the effective interest method retrospectively.

A11(d) Hedge accounting

The hedge accounting requirements in Part II of Section 11 are applied prospectively from the date of initial application.

COMPARISON WITH FULL IFRS ACCOUNTING STANDARDS

The main differences between the requirements in full IFRS Accounting Standards (see IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures*) and those in the *IFRS for SMEs* Accounting Standard (see Section 11 *Financial Instruments*) as at February 2025 include:

Comparison with IFRS 9

(a) *Classification of financial instruments:*

- (i) IFRS 9 requires financial assets to be classified based on the entity's business model for managing the financial asset and the contractual cash flow characteristics of the financial asset. Financial liabilities are generally measured at amortised cost, with some exceptions.
- (ii) Section 11 classifies financial assets and financial liabilities as either basic or more complex based on their terms and conditions. Section 11 includes a supplementary principle to classify financial instruments based on the contractual cash flows characteristics and does not require classification based on the entity's business model.

(b) *Initial recognition and measurement:*

- (i) Financial assets and financial liabilities are recognised when the entity becomes party to the contractual provisions of the instrument applying IFRS 9 and Section 11.
- (ii) Financial assets and financial liabilities in the scope of IFRS 9 are measured at fair value on initial recognition, with the exception of some trade receivables.
- (iii) Financial assets and financial liabilities in the scope of Part I of Section 11 are measured at transaction price unless the financial asset is a trade receivable or the arrangement constitutes a financing transaction. Financial assets and financial liabilities in the scope of Part II of Section 11 are measured at their fair value on initial recognition.

(c) *Subsequent measurement:*

- (i) Financial assets in the scope of IFRS 9, depending on their classification, are measured at fair value through profit or loss, fair value through other comprehensive income or amortised cost. IFRS 9 does not permit any instruments to be measured at cost. Based on their classification, IFRS 9 requires an entity to measure a financial liability either at fair value through profit or loss or amortised cost.
- (ii) Basic financial instruments (that is, financial assets and financial liabilities) in the scope of Part I of Section 11 are generally measured at amortised cost and those in the scope of Part II of Section 11 are measured at fair value through profit or loss. Investments in equity instruments that are publicly traded or whose fair value can be reliably measured without undue cost or effort are measured at fair value through profit or loss, while other investments in equity instruments are measured at cost less impairment.

(d) *Impairment:*

  (i) IFRS 9 requires an entity to impair financial assets applying an expected credit losses model.

  (ii) Section 11 requires an entity to impair financial assets that are measured at cost or AC when there is objective evidence that the financial asset is impaired (incurred losses).

(e) *Derivative financial instruments:*

  (i) IFRS 9 permits separation of embedded derivatives, unless certain conditions apply.

  (ii) Section 11 does not permit separation of embedded derivatives.

(f) *Hedge accounting:*

  (iii) IFRS 9 permits hedge accounting for a broader range of risks, instruments and transactions, with strict qualifying criteria such as the hedging relationship meeting the hedge effectiveness requirements.

  (iv) Section 11 permits hedge accounting only for specific risks listed in paragraph 11.63 of Section 11, and only if the hedging instrument has the characteristics indicated in paragraph 11.64 of Section 11.

Comparison with IFRS 7

The following table sets out the disclosures in IFRS 7 compared with the disclosures in Section 11.

IFRS 7 paragraph	*IFRS for SMEs* Accounting Standard paragraph
X	11.39
X	11.43
X	11.44
6	X
B13	X
3(a), 5A	X
7	11.42
8(a)	11.41(a)
8(e)	11.41(d)
8(f)	11.41(b)
8(g)	11.41(e)
8(h)	X
X	11.41(c)–(f)
9	X
10(a)–(d)	X
10A	X
11,11A,11B	X
12B	X
12C	X
12D	X
13C(a),(b)	X
13A, 13B,13D,13E,13F	X
13C(b)–(e)	X
14	11.46
15	X
16A	X
17	X
18	11.47
19	11.47
20	11.48(a) and (b)
X	11.48 (c)

IFRS 7 paragraph	*IFRS for SMEs* Accounting Standard paragraph
20A	X
21	11.40
21A–21D	X
22A	X
X	11.72
22B(a) and (b)	11.73
22B(c)	X
22C(a)	X
22C(b)	X
23A–23F	X
24A	11.74
24B, 24C	11.75
24D–24G, 24I	X
24H	X
24J (a)–(b)	X
24J(c)	X
25	X
26	X
28	X
29	X
31	X
32	X
32A	X
33	X
34	X
35	X
35A–35E	X
35F(a) and (b)	X
35F(c)–(f)	X
35G	X

IFRS 7 paragraph	*IFRS for SMEs* Accounting Standard paragraph
35H	X
B8A–B8D	X
B8E	X
35I	X
35J–35L	X
35M	X
35N	X
36	X
38	X
39(a) and (b)	11.43A
39(c)	X
X	11.43B
40	X
41	X
42	X
42A–42C, 42E–42S	X
B42	X
42D(c), (d) and (f)	X
42D(a), (b) and (e)	11.45

TEST YOUR KNOWLEDGE—PART I OF SECTION 11

Test your knowledge of the requirements in Part I of Section 11 *Financial Instruments* of the *IFRS for SMEs* Accounting Standard by answering the questions provided.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those supplied on page 188.

Mark the box next to the most correct statement.

Question 1

Which of the following items in an entity's statement of financial position is a financial asset or financial liability within the scope of Part I 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 2

Which of the following financial assets is not within the scope of Part I 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.

Question 3

Which of the following financial instruments is not within the scope of Part I 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 4

An SME 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 SME measure the investment in shares on initial recognition?

- ☐ (a) CU1,900.
- ☐ (b) CU2,000.
- ☐ (c) CU2,100.

Question 5

A bank provides an SME with a five-year loan for CU10,000 with fixed interest payable annually in arrears at a rate of 6% of the principal amount. Six per cent is considered to be the market rate for a similar five-year loan with interest payable annually in arrears. The bank charges the SME a fee of CU50 for paperwork.

At what amount should the SME measure the loan on initial recognition?

- ☐ (a) CU9,384.
- ☐ (b) CU9,484.
- ☐ (c) CU9,950.
- ☐ (d) CU10,000.
- ☐ (e) CU10,050.

Question 6

At the end of each reporting period investments in non-convertible preference shares and non-puttable ordinary or preferences 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.

Question 7

On 1 January 20X1 an SME 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 8

When assessing financial assets held at amortised cost or cost for impairment, an SME 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 9

An SME sells a group of its accounts receivable to a bank at less than their carrying amount. The SME continues to handle collections from the debtors on behalf of the bank, and the bank pays the SME a market-rate fee for servicing the receivables. The SME 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 SME 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 SME 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 SME 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 SME 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.

Answers

Q1 (a) see paragraph 11.3

Q2 (d) see paragraph 11.7(a)

Q3 (b) see paragraph 11.7(b)

Q4 (b) see paragraph 11.13

Q5 (c) see paragraph 11.13

Q6 (e) see paragraph 11.14

Q7 (b) see paragraph 11.16

Q8 (e) see paragraph 11.24

Q9 (a) see paragraphs 11.33–11.35

APPLY YOUR KNOWLEDGE

You can apply your knowledge of the requirements in Part I of Section 11 of the *IFRS for SMEs* Accounting Standard by completing the case studies provided.

Once you have completed a case study, check your answers against those on pages 191–192 for Case Study 1 and pages 195–206 for Case Study 2.

Case Study 1

An SME has the following trial balance for the year ended 31 December 20X2.

			Subsequent measurement under Section 11		
	20X2 CU	***In scope of 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				

			Subsequent measurement under Section 11		
	20X2 CU	In scope of Section 11?	Fair value	Amortised cost	Cost less impairment
Bank loans (Fixed-term. Fixed-interest)	(110,000)				
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
	(0)

Using the columns on the right, note which items are within the scope of Part I 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.

Answer to Case Study 1

			Subsequent measurement under Section 11		
	20X2 CU	***In scope of Section 11?***	***Fair value***	***Amortised cost***	***Cost less impairment***
Opening retained earnings	(1,961,353)	No. SME's own equity. See Section 22 (paragraph 11.7(b)).			
Share capital (40,000 ordinary shares with par value CU1.00)	(40,000)	No. SME'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.		√	
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 preference shares in an unlisted company	3,210	Yes.	√ If fair value can be measured reliably without undue cost or effort (paragraph 11.14(c)(ii)).		√ If fair value can be 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.			

			Subsequent measurement under Section 11		
	20X2 CU	***In scope of Section 11?***	***Fair value***	***Amortised cost***	***Cost less impairment***
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.		√	
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.		√	
Interest payable	(2,000)	Yes.		√	
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).		√	

Case Study 2

On 1 January 20X1 SME 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 SME 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 SME 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 six years. Interest is charged at SONIA 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 SONIA 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 SME A already has a five-year loan with another bank for CU5,000. Interest is charged at SONIA plus 200 points. The market rate for similar loans is SONIA plus 200 points. Interest is payable annually in arrears and the SME 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. SME 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 SONIA is a weighted average of 3% and during 20X2 it is a weighted average of 2.5%.

Part A

Prepare the journal entries for 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 all of loans receivable and payable described in the case study 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).

Answer to Case Study 2—Part A

(1) Loan to employee (financial asset)

The loan is measured 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. It will either be recognised immediately in profit or loss or deferred depending on whether there are further service 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)

Interest is receivable at the market rate of 5%, the SME 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.

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

(3) Three-year fixed rate bank loan (financial liability)

Interest is payable at the market rate of 6%, the SME initially records the loan receivable at the transaction price (that is, CU10,000[(c)]) minus 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 administration costs.

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%:

Time	*Cash payable (a)*	*Discount factor (6%) (b)*	*Present value (a) x (b)*
20X1	600	0.9434	566.04
20X2	600	0.8900	534.00
20X3	10,600	0.8396	8,899.96
		Total	10,000.00

(4) Overdraft (financial liability)

The overdraft is repayable on demand, the SME 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.

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 when 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.

(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 – 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

To recognise interest earned in 20X1.

Dr Profit or loss—impairment loss	CU714.85	
Cr Loan receivable (financial asset)		CU714.85

To recognise the impairment of the loan receivable (capital and interest) to its recoverable amount of CU4,535.15 on 31 December 20X1.

The journal entries in 20X2 are:

Dr Loan receivable (financial asset)	CU226.76[g]	
Cr Profit or loss—interest income		CU226.76

To recognise interest earned in 20X2.

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.

[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):

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 are:

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.		

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 inflow*	*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 because 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 because it is repayable on demand.

(5) Variable rate bank loan

Interest is payable at the market rate for this type of loan, the loan is recorded by the SME 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 recognise interest expense accrued in 20X1 (that is, CU5,000 × 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 SONIA varies. However, because interest is charged at the market rate for this type of loan, if the effective interest rate is set to SONIA 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 × 4.5%[j]).

At 31 December 20X1 the loan has a carrying amount of CU5,000.

[i] During 20X1 SONIA is a weighted average of 3% and therefore the weighted average interest on the loan is 5% (that is, 3% plus 200 basis points).

[j] During 20X2 SONIA 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).

Answer to Case Study 2—Part C

[Extract from] SME A group notes for the year ended 31 December 20X2.

Note 1 Accounting policies

Financial instruments

SME A applies Section 11 *Financial Instruments* of the *IFRS for SMEs* Accounting 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

SME 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 loans 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 CU	***20X1 CU***
Interest income[q]	261	283

Note 9 Finance costs

	20X2 CU	***20X1 CU***
Interest on bank overdraft and loans[r]	913	925

Note 10 Profit for the year

	20X2 CU	20X1 CU
Impairment of loan to associate	–	715

Note 14 Carrying amounts of financial assets and financial liabilities in SME A's statement of financial position at 31 December 20X2[13]

	Note	20X2 CU	20X1 CU
Financial assets			
Investments in equity instruments		X	X
Loans receivable	25	4,762	5,021
Trade receivables		X	X
Total		X	X
Financial liabilities			
Trade and other payables		X	X
Overdraft	26	1,299	944
Bank loans	26	14,965	14,931
Total		X	X

Note 25 Loans receivable

	20X2 CU	20X1 CU
Loan to employee	–	486
Loan to associate	4,762	4,535
Total	4,762	5,021

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.

13 In this example, the SME has not disclosed the categories of financial assets and financial liabilities, as required by paragraph 11.41 in the notes, but rather has presented the categories on the statement of financial position.

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	16,264	15,875

The bank overdraft is repayable on demand. Interest is payable on the bank overdraft at SONIA 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 SONIA plus 200 points (20X1: SONIA plus 200 points).

The calculations and explanatory notes below do not form part of the answer to this case study:

(q) 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

Note 27 Maturity analysis

The table analyses the Entity's financial liabilities based on their remaining contractual maturities. The amounts are the contractual undiscounted cash flows, including interest payments.

	Total	Less than 1 month	1–3 months	3 months –1 year	1–5 years
	CU	CU	CU	CU	CU
20X2					
Fixed rate bank loan	11,200	–	–	600	10,600
Bank overdraft	1,299	1,299	–	–	–
Variable rate bank loan	5,675	–	–	225	5,450
20X1					
Fixed rate bank loan	11,800	–	–	600	11,200
Bank overdraft	944	944	–	–	–
Variable rate bank loan	6,000	–	–	250	5,750

Note 28 Analysis of age loan receivables

The table analyses the age of the Entity's loan receivables by reference to due date.

	Not yet due	Less than 1 month	1–3 months	3 months –1 year	1–5 years	More than 5 years	Total
	CU	CU	CU	CU	CU	CU	CU
20X2							
Amortised cost before impairment	5,477	–	–	–	–	–	5,477
Impairment	(715)	–	–	–	–	–	(715)
	4,762	–	–	–	–	–	4,762
20X1							
Amortised cost before impairment	5,763	–	–	–	–	–	5,763
Impairment	(715)	–	–	–	–	–	(715)
	5,021	–	–	–	–	–	5,021

TEST YOUR KNOWLEDGE – PART II OF SECTION 11

Test your knowledge of the requirements in Part II of Section 11 of the *IFRS for SMEs* Accounting Standard by answering the questions provided.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those on page 212.

Mark the box next to the most correct statement.

Question 1

Which one of the following financial instruments held by an SME is within the scope of Part II of Section 11?

☐ (a) a loan from a bank with a rate of interest equal to a single referenced quoted interest rate.

☐ (b) a financial instrument that qualifies and is designated as a hedging instrument applying the Standard.

☐ (c) a quoted fixed-interest bond.

☐ (d) an obligation to pay employees who serve throughout the year a specified proportion of profit earned by the SME for that year. The payment will be made nine months after year-end.

☐ (e) an obligation under a finance lease to pay a stream of payments to a lessor. The lease does not contain any unusual embedded risks.

Question 2

Which two of the following financial instruments held by an SME can be within the scope of Part II of Section 11?

☐ (a) trade receivables.

☐ (b) a 5% holding in the non-puttable ordinary shares of another entity (investee).

☐ (c) a 30% holding in the non-puttable ordinary shares of another entity (investee) where the investee is classified as an associate of the SME.

☐ (d) a contract to purchase FCU500 for CU10,000 in four months.

Question 3

Which one of the following contracts is within the scope of Part II of Section 11?

- ☐ (a) a contract to purchase a property in six months that could result in an additional payment of 10% of the purchase price if the consumer price index in the jurisdiction of the property increases by 1% during the six-month period.
- ☐ (b) a contract to purchase a property in six months that could result in an additional payment of 1% of the purchase price if the consumer price index in the jurisdiction of the property increases by 1% during the six month period.
- ☐ (c) a contract to sell a property in six months that could result in a loss to the seller if the buyer defaults because of financial difficulties.
- ☐ (d) a contract to sell a property in six months to an overseas buyer for CU1,000,000 that could result in a loss to the buyer if the currency in the buyer's jurisdiction depreciates against CU during the six-month period.

Question 4

An SME enters into a futures contract to purchase 20,000 bushels of wheat in six months at a fixed price in accordance with its expected usage requirements (a fixed price future). The contract permits the SME to take physical delivery of the wheat at the end of six months or to pay or receive a net settlement in cash at the end of six months.

Which of the following statements is true?

- ☐ (a) The contract is within the scope of Part II of Section 11 because it can be net settled in cash.
- ☐ (b) The contract is outside the scope of Part II of Section 11 because it is a contract for the purchase of a non-financial asset.
- ☐ (c) The contract is outside the scope of Part II of Section 11 only if the SME intends to accept delivery of the wheat.
- ☐ (d) The contract is within the scope of Part II of Section 11 because it is a hedging instrument.

Question 5

On 1 January 20X0, an SME purchased 100 share options from a bank for cash of CU2,000 in an arm's length transaction. The share options permit the SME to purchase shares in a listed entity, XYZ, for CU50 per share at any time during the next two years. XYZ's share price is currently quoted at CU44 per share.

On 1 January 20X0 the SME paid transaction fees of CU20 for the purchase of the options.

At what amount should the SME measure the 100 share options purchased on initial recognition?

- ☐ (a) CU1,380.
- ☐ (b) CU1,980.
- ☐ (c) CU2,000.
- ☐ (d) CU2,020.
- ☐ (e) CU4,040.

Question 6

The facts are the same as in Question 5. On 31 December 20X0 the option has not yet been exercised and the shares are trading at CU47 per share. The fair value of the option has increased to CU2,500.

At what amount should the SME subsequently measure the 100 share options held on 31 December 20X0?

- ☐ (a) CU1,980.
- ☐ (b) CU2,000.
- ☐ (c) CU2,020.
- ☐ (d) CU2,500.
- ☐ (e) CU4,700.

Question 7

Which of the following statements is true for an SME that does not apply hedge accounting?

- ☐ (a) At the end of each reporting period, an SME must measure all financial instruments within the scope of Part II of Section 11 at fair value and recognise changes in fair value in profit or loss.
- ☐ (b) At the end of each reporting period, an SME must measure all publicly traded financial instruments within the scope of Part II of Section 11 at fair value and recognise changes in fair value in profit or loss. Financial instruments not publicly traded are measured at cost less impairment.
- ☐ (c) At the end of each reporting period, an SME must measure all financial instruments within the scope of Part II of Section 11 at fair value and recognise changes in fair value in profit or loss, except equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably without undue cost or effort (and contracts linked to such instruments that, if exercised, will result in delivery of such instruments), which are measured at cost less impairment.
- ☐ (d) At the end of each reporting period, an SME must measure all financial instruments within the scope of Part II of Section 11 at cost less impairment.

Question 8

Part II of Section 11 permits hedge accounting for selected risks. Which of the following risks is *not* permitted for hedge accounting under Part II of Section 11?

- ☐ (a) interest rate risk of a debt instrument measured at amortised cost.
- ☐ (b) foreign exchange risk of a debt instrument measured at amortised cost.
- ☐ (c) foreign exchange risk in a firm commitment.
- ☐ (d) foreign exchange risk in a net investment in a foreign operation.

Question 9

A jeweller that is an SME holds an inventory of miniature gold ingots for use in a range of jewellery that will be ready for sale in roughly three months. The SME is worried that the price of gold may decline in the next three months and to hedge this risk, the SME enters into a commodity forward contract that can be net settled to hedge the commodity price risk of the commodity it holds. This relationship meets the conditions for hedge accounting; the SME documents the hedge and chooses to apply hedge accounting. Which of the following is the appropriate accounting treatment?

☐ (a) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in profit or loss. Recognise the change in the fair value of the gold inventory in profit or loss and as an adjustment to the carrying amount of the gold inventory.

☐ (b) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in profit or loss. Recognise the change in the fair value of the gold inventory attributable to the hedged risk in profit or loss and as an adjustment to the carrying amount of the gold inventory.

☐ (c) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in other comprehensive income. Recognise the change in the fair value of the gold inventory attributable to the hedged risk in other comprehensive income and as an adjustment to the carrying amount of the gold inventory.

☐ (d) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in other comprehensive income. Do not recognise any change in the fair value of the gold inventory because inventory is measured at cost.

Question 10

Under what circumstances must an SME discontinue hedge accounting for a hedging relationship that previously met the requirements to qualify for hedge accounting as set out in paragraph 11.62?

☐ (a) The hedging instrument expires or is sold or terminated.

☐ (b) The hedge no longer meets the conditions for hedge accounting specified in paragraph 11.62.

☐ (c) The SME revokes the designation.

☐ (d) In a hedge of a forecast transaction, the forecast transaction is no longer highly probable.

☐ (e) Any of (a)–(d).

Answers

Q1 (b) see paragraphs 11.49, 11.8 and 11.9

Q2 (a) and (d) see paragraphs 11.49 and 11.8

Q3 (a) see paragraph 11.50

Q4 (c) see paragraph 11.51

Q5 (c) see paragraph 11.52

Q6 (d) see paragraph 11.54

Q7 (c) see paragraph 11.54

Q8 (b) see paragraph 11.63

Q9 (b) see paragraph 11.65

Q10 (e) see paragraphs 11.67 and 11.71

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements in Part II of Section 11 of the *IFRS for SMEs* Accounting Standard by completing the case studies provided.

Once you have completed a case study, check your answers against those on pages 215–219 for Case Study 3 and pages 221–223 for Case Study 4.

Case Study 3

On 1 November 20X0 SME A, whose functional currency is CU, enters into a firm commitment with SME B, whose functional currency is FCU, to purchase an item of specialised equipment for FCU750,000 for use within the sales function of SME A's business. Both delivery and payment are scheduled for 1 July 20X1.

Also on 1 November 20X0, SME A enters into a foreign currency forward exchange contract (forward contract) with an external party to buy FCU750,000 and sell CU500,000 on 1 July 20X1. SME A enters into the forward contract to hedge its future exposure to FCU arising from the firm commitment with SME B. As a result of the contract, SME A will receive and pay FCU750,000 on the single date, and hence, when viewed from a net position, it has no exposure to change in the FCU/CU exchange rate. The forward contract effectively 'locks in' the exchange rate at FCU1.5/CU1 for FCU750,000. The fair value of the forward contract at inception (on 1 November 20X0) is zero. The forward contract has no prepayment, early termination or extension features.

The spot rate at:

- 1 November 20X0 = FCU1.55/CU1
- 31 December 20X0 = FCU1.47/CU1
- 1 July 20X1 = FCU1.2/CU1

All changes in fair value of the currency forward are due to changes in the spot and forward FCU/CU exchange rates.

The fair value of the currency forward at various dates is shown in the table:

	1 November 20X0	*31 December 20X0*	*1 July 20X1*
Fair value of forward contract	CU0	CU24,475	CU125,000

From 1 July 20X1 SME A will, applying Section 17, depreciate the equipment on the straight-line method over its estimated useful life of 15 years to a residual value of CU25,000 (estimated net proceeds that would be obtained on 1 July 20X1 from disposal of the equipment if the equipment were already 15 years old and in the condition expected at the end of its useful life).

SME A has a 31 December financial year-end.

SME A does not recognise executory contracts[14] unless explicitly required to do so by the Standard (for example, when executory contracts are onerous, a provision is recognised applying Section 21). On 1 July 20X1 the recoverable amount of the specialised equipment is expected to be at least CU625,000.

Part A:

SME A chooses not to use hedge accounting under Part II of Section 11.

Prepare the journal entries necessary for the transactions for the year ended 31 December 20X0 and for the year ended 31 December 20X1.

Part B:

SME A wishes to designate a hedging relationship between the forward contract and the foreign exchange risk in the firm commitment in such a way as to qualify for hedge accounting.

Can SME A use hedge accounting for the hedging relationship between the forward contract and the foreign exchange risk in the firm commitment? If so, what actions must management take in order to use hedge accounting?

Part C:

Unlike in Part A, in this part (Part C) SME A does use hedge accounting applying Section 11.

Prepare journal entries for the transactions for the year ended 31 December 20X0 and for the year ended 31 December 20X1. Ignore the time value of money.

Part D:

The facts are the same as in Part C. On 31 December 20X2 the equipment has a recoverable amount of CU400,000 because of damage from bad weather conditions experienced towards the end of 20X2.

Prepare journal entries to record the transactions for the year ended 31 December 20X2.

Part E:

The facts are the same as in Part D. On 1 January 20X3 management estimates that the equipment has a residual value of CU20,000. Estimated useful life remains 15 years from the original date of acquisition. On 31 May 20X3 the equipment is sold for CU390,500 because of changes in business plans.

Prepare journal entries to record the transactions for the year ended 31 December 20X3.

14 Contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (see paragraph 21.2 of the Standard).

Answer to Case Study 3

Part A:

1 November 20X0

Because the forward contract has a fair value of zero on 1 November 20X0, no entries are required on initial recognition.

The firm commitment to buy the equipment entered into on 1 November 20X0 is outside the scope of Part II of Section 11, because contracts that were entered into, and continue to be held, for the purpose of the receipt of a non-financial item in accordance with the entity's expected usage requirements are not financial instruments for the purposes of Part II of Section 11, even if the contract can be net settled; see paragraph 11.51. Because the contract is not onerous, applying SME A's accounting policies, no entries are made for the commitment entered into on 1 November 20X0 to buy the equipment.

31 December 20X0

Dr	Asset: financial asset—forward contract	CU24,475	
Cr	Income: profit or loss—change in fair value of forward contract[15]		CU24,475

To recognise the change in the fair value of the forward contract between 1 November 20X0 and 31 December 20X0.

No entries are required at 31 December 20X0 for the firm commitment entered into on 1 November 20X0 to buy the equipment (for the same reasons as at 1 November 20X0).

1 July 20X1

Dr	Asset: financial asset—forward contract	CU100,525[(a)]	
Cr	Income: profit or loss—change in fair value of forward contract		CU100,525

To recognise the change in the fair value of the forward contract from 1 January 20X1 to 1 July 20X1.

Dr	Asset: financial asset—cash	CU125,000	
Cr	Asset: financial asset—forward contract		CU125,000

To recognise the settlement under the forward contract on expiry (pay CU500,000 to receive FCU750,000 (= CU625,000)).

Dr	Asset: property, plant and equipment—equipment cost	CU625,000[(b)]	
Cr	Asset: financial asset—cash		CU625,000

To recognise the purchase of the equipment on 1 July 20X1 in exchange for FCU750,000 (= CU625,000).

15 Changes in fair value are recognised in profit or loss because the forward contract is not designated as a hedging instrument.

31 December 20X1

Dr	Expense: profit or loss—depreciation	CU20,000[c]	
Cr	Asset: property, plant and equipment—equipment accumulated depreciation		CU20,000

To recognise depreciation on the equipment for the six months between 1 July 20X1 and 31 December 20X1.

Note: on 31 December 20X1, the carrying amount of the equipment is an asset of CU605,000.[c]

Part B:

SME A may designate a hedging relationship between the forward contract and the foreign exchange risk in the firm commitment and apply hedge accounting, applying paragraph 11.69, provided that SME A designates and documents the hedging relationship appropriately; the other conditions in paragraph 11.62 appear to be satisfied, as follows:

- The hedged risk—foreign exchange risk in a firm commitment—is one of the risks specified in paragraph 11.63.
- A foreign currency forward exchange contract is one of four hedging instruments specified in paragraph 11.64. The contract also meets all the other conditions in paragraph 11.64: the forward contract is entered into with a party external to SME A; the foreign currency amount in the forward contract is equal to the purchase price of FCU750,000; the maturity date of the forward contract is the same as the date of the firm commitment and the forward contract has no prepayment, early termination or extension features.
- The principal terms of the forward contract and of the firm commitment, which relate to foreign exchange risk, match, so the changes in the fair value of the forward contract are expected to be, both at inception and subsequently, highly effective in offsetting the changes in the expected cash flow from the firm commitment that is attributable to foreign exchange risk. The principal terms include the maturities of the commitment and the forward exchange contract (in eight months), the foreign currency (FCU), and the amount of each (FCU750,000). In addition, the fair value of the forward contract at inception is zero.

However, potential sources of ineffectiveness include subsequently agreed changes in the date of sale of the equipment, termination of the contract by both parties and changes in the creditworthiness of the counterparty to the forward contract.

Part C:

1 November 20X0

Because the forward contract has a fair value of zero on 1 November 20X0, no entries are required on initial recognition.

The firm commitment entered into on 1 November 20X0 to buy the equipment is outside the scope of Part II of Section 11, because contracts that were entered into, and continue to be held, for the purpose of the receipt of a non-financial item, in accordance with the SME's expected usage requirements are not financial instruments for the purposes of Part II of Section 11, even if the contract can be net settled; see paragraph 11.51. Because the contract is not onerous, applying SME A's accounting policies, no entries are made for the commitment entered into on 1 November 20X0 to buy the equipment.

31 December 20X0

Dr	Asset: financial asset—forward contract	CU24,475	
	Cr Income: OCI-change in fair value (hedging instrument)		CU24,475

To recognise the change in the fair value of the forward contract between 1 November 20X0 and 31 December 20X0 applying paragraph 11.69.

No entries are required at 31 December 20X0 for the firm commitment entered into on 1 November 20X0 to buy the equipment (for the same reasons as at 1 November 20X0).

1 July 20X1

Dr	Asset: financial asset—forward contract	CU100,525[(a)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU100,525

To recognise the change in the fair value of the forward contract between 1 January 20X1 and 1 July 20X1 applying paragraph 11.69.

Dr	Asset: financial asset—cash	CU125,000	
	Cr Asset: financial asset—forward contract		CU125,000

To recognise the settlement under the forward contract on expiry (on 1 July 20X1).

Dr	Asset: property, plant and equipment—equipment	CU625,000[(b)]	
	Cr Asset: financial asset—cash		CU625,000

To recognise the purchase of the equipment on 1 July 20X1.

31 December 20X1

Dr	Expense: profit or loss—depreciation	CU20,000[(c)]	
	Cr Asset: property, plant and equipment—equipment accumulated depreciation		CU20,000

To recognise depreciation on the equipment for the six months between 1 July 20X1 and 31 December 20X1.

Dr	Income: OCI-change in fair value (hedging instrument)	CU4,167[f]	
	Cr Income: profit or loss—reclassification of hedging gain		CU4,167

To reclassify an appropriate portion of the cumulative hedging gain from other comprehensive income to profit or loss because the equipment is depreciated.

On 31 December 20X1 the carrying amount of the equipment is an asset of CU605,000,[c] and CU120,833[f] of cumulative hedging gains in other comprehensive income is still to be reclassified in relation to that asset.

Part D:

31 December 20X2

Dr	Expense: profit or loss—depreciation	CU40,000[c]	
	Cr Asset: property, plant and equipment—equipment accumulated depreciation		CU40,000

To recognise depreciation on the equipment for the year ended 31 December 20X2.

Dr	Expense: profit or loss—impairment	CU165,000[g]	
	Cr Asset: property, plant and equipment—equipment (accumulated impairment and accumulated depreciation)		CU165,000

To recognise the impairment of the equipment at 31 December 20X2.

Dr	Income: OCI-change in fair value (hedging instrument)	CU42,708[h]	
	Cr Income: profit or loss—reclassification of hedging gain		CU42,708

To reclassify an appropriate portion of the cumulative hedging gain from other comprehensive income to profit or loss because the equipment is depreciated and impaired.

On 31 December 20X2 the carrying amount of the equipment is an asset of CU400,000, and CU78,125[i] of cumulative hedging gains in other comprehensive income is still to be reclassified in relation to that asset.

Part E:

31 May 20X3

Dr	Expense: profit or loss—depreciation	CU11,728[j]	
	Cr Asset: property, plant and equipment—equipment (accumulated depreciation and accumulated impairment)		CU11,728

To recognise depreciation on the equipment for the five months between 1 January 20X3 and 31 May 20X3.

Dr	Asset: financial asset—cash	CU390,500	
Dr	Asset: property, plant and equipment—equipment (accumulated depreciation and accumulated impairment)	CU236,728[(k)]	
	Cr Asset: property, plant and equipment—equipment (cost)		CU625,000
	Cr Income: profit or loss: gain on disposal of equipment		CU2,228[(k)]

To recognise the sale of the equipment on 31 May 20X3.

Dr	Income: OCI-change in fair value (hedging instrument)	CU78,125[(i)]	
	Cr Income: profit or loss		CU78,125

To reclassify the cumulative hedging gain from other comprehensive income to profit or loss because the equipment is depreciated and to reclassify the remaining balance in the account on the sale of the equipment.

Calculations and explanatory notes:

(a) Change in fair value between 1 January 20X0 and 1 July 20X1: CU125,000 – CU24,475 = CU100,525.

(b) Cost of equipment: FCU750,000 ÷ 1.2 (spot rate on 1 July 20X1) = CU625,000.

(c) Depreciable amount: CU625,000 – CU25,000 = CU600,000.

Annual depreciation charge: CU600,000 ÷ 15 = CU40,000.

Depreciation charge for the six months from 1 July 20X1 to 31 December 20X1: CU20,000.

Carrying amount of equipment at 31 December 20X1: CU625,000 – CU20,000 = CU605,000.

(d) The change in fair value of the forward contract is recognised in full in OCI because the hedge is fully effective:
Change in fair value of the expected cash flows = present value of (FCU750,000/1.55 – FCU750,000/1.47) = present value of (CU483,871 – CU510,204) = present value of CU(26,333).

The instructions say to ignore discounting, so for this purpose the change in the fair value of the expected cash flows = CU(26,333).

Because the change in the fair value of the expected cash flows is greater than the change in the fair value of the hedging instrument, there is no hedge ineffectiveness.

(e) Change in fair value of the expected cash flows, ignoring discounting = FCU750,000/1.47 – FCU750,000/1.20 = CU510,204 – CU625,000 = CU(114,796).

Because the change in the fair value of the expected cash flows is greater than the change in the fair value of the hedging instrument, there is no hedge ineffectiveness.

(f) Cumulative exchange gain recognised in other comprehensive income = CU24,475 + CU100,525 = CU125,000.

Reclassification of cumulative exchange gain to match with annual depreciation = CU125,000 ÷ 15 = CU8,333.

Reclassification of cumulative exchange gain to match with six months' depreciation = CU8,333 ÷ 2 = CU4,167.

Because the total depreciable amount of the equipment is CU600,000, an alternative method of calculation is (CU20,000 ÷ CU600,000) × CU125,000 = CU4,167.

Amount still to be reclassified at 31 December 20X1 = CU125,000 l – CU4,167 = CU120,833.

(g) Additional impairment charge = CU605,000 – CU40,000 – CU400,000 = CU165,000.

(h) Appropriate reclassification of cumulative exchange gain for annual depreciation charge and impairment charge = (CU165,000 + CU40,000) ÷ CU600,000 × CU125,000 = CU42,708.

(i) Amount of cumulative exchange gains in other comprehensive income still to be reclassified at 31 December 20X2 = CU120,833[(f)] – CU42,708[(h)] = CU78,125.

(j) Depreciable amount at 1 January 20X3 = CU400,000 – CU20,000 = CU380,000. Depreciation for the five months ended 31 March 20X3 = CU380,000 ÷ 13.5 × 5 ÷ 12 = CU11,728.

(k) Carrying amount of the equipment on 31 May 20X3 = CU400,000 – CU11,728 = CU388,272.

Profit on sale = CU390,500 – CU388,272 = CU2,228.

Total accumulated depreciation and impairment at 31 May 20X3 = CU20,000 + CU40,000 + CU165,000 + CU11,728 = CU236,728.

Case Study 4

The facts are the same as in Case Study 3. As in Part C of that case study, assume that SME A designates a hedging relationship between the forward contract and the foreign exchange risk in the firm commitment in such a way as to qualify for hedge accounting.

Prepare disclosures sufficient to satisfy the requirements in Section 11 both for the year ended 31 December 20X0 and the year ended 31 December 20X1.

Answer to Case Study 4

Extract from SME A's statement of comprehensive income for the year ended 31 December 20X0

	Note	20X0 CU	20W CU
Profit for the year[a]		XXX,XXX	XXX,XXX
Other comprehensive income:			
…			
Items that may be reclassified subsequently to profit or loss:			
Gains on hedges of foreign exchange	18	24,475[b]	–
Other comprehensive income for the year, net of taxes		**XXX,XXX**	**XXX,XXX**
Total comprehensive income for the year		**XXX,XXX**	**XXX,XXX**

Extract from SME A's notes to the financial statements for the year ended 31 December 20X0

Note 2 Accounting policies

Foreign exchange forward contracts

Foreign exchange forward contracts are occasionally entered into to manage exposure to foreign exchange rate risk on firm commitments or highly probable forecast transactions to purchase specialised imported equipment.

Forward contracts are initially recognised at fair value at the date the contract is entered into and are subsequently remeasured to their fair value at the end of each reporting period. The resulting gain or loss is recognised in profit or loss immediately, unless the forward contract is designated and effective as a hedging instrument, in which case the effective portion of the gain or loss is recognised in other comprehensive income and the ineffective portion, if any, is recognised in profit or loss.

Amounts previously recognised in other comprehensive income are reclassified to profit or loss in the periods when the cost of the specialised equipment is recognised in profit or loss in the form of depreciation/impairment, or on sale.

Hedge accounting is discontinued if the hedging relationship is revoked, if the forward contract expires, is sold, terminated or exercised or when the relationship no longer qualifies for hedge accounting. Provided the forecast transaction is still highly probable, any cumulative gain or loss recognised up to that date continues to be deferred in other comprehensive income and will be recognised in profit or loss when the specialised equipment is depreciated, impaired or sold. If a hedged forecast transaction or firm commitment is no longer expected to occur, the cumulative gain or loss recognised in other comprehensive income is recognised immediately in profit or loss.

The fair value of the foreign exchange forward contracts is determined by reference to forward exchange rates for contracts which, at the end of the reporting period, have the same maturities as those held by the entity, and discounting the difference between the cash flows specified in the contract held by the entity and those that would occur using the forward rate relevant at the end of the reporting period, using a risk free rate, usually EURIBOR, to reflect the time value of money.

Note 18 Hedge reserve

On 1 November 20X0, the company entered into a firm commitment to purchase an item of specialised equipment for FCU750,000 with cash payment to be made on the delivery date of 1 July 20X1.
On 1 November 20X0, the company also entered into an eight-month foreign currency forward contract and designated it as a hedge of the foreign exchange risk under the firm commitment.

On 31 December 20X0, the fair value of the forward contract was CU24,475, the entire amount of which represents a gain. The entire gain of CU24,475 was recognised in other comprehensive income. The net gain or loss at 1 July 20X1 will be reclassified to profit or loss in the same periods during which the specialised equipment affects profit or loss. This will be in the periods following 1 July 20X1 when the equipment is depreciated or any impairment expense is recognised. The item of equipment will be depreciated from 1 July 20X1 over its 15-year life to its scrap value.

In 20X0 (and 20W9) the company had no other hedging relationships.

Extract from SME A's statement of comprehensive income for the year ended 31 December 20X1

	Note	**20X1 CU**	**20X0 CU**
Profit for the year		XXX,XXX	XXX,XXX
Other comprehensive income:			
Items that may be reclassified subsequently to profit or loss:			
…			
Gains on hedges of foreign exchange net of gains reclassified to profit or loss	20	96,358[(c)]	24,475
Other comprehensive income for the year, net of taxes		**XXX,XXX**	**XXX,XXX**
Total comprehensive income for the year		**XXX,XXX**	**XXX,XXX**

Extract from SME A's notes to the financial statements for the year ended 31 December 20X1

Note 2 Accounting policies

Same as in extracts from financial statements for the year ended 31 December 20X0.

Note 20 Hedge reserve

On 1 July 20X1 the company purchased an item of equipment for FCU750,000 (CU625,000); the contract for the purchase was entered into on 1 November 20X0. On 1 November 20X0, the company also entered into an eight-month foreign currency forward contract, to receive FCU750,000 and pay CU500,000, and designated it as a hedge of the foreign exchange risk under the firm commitment. The hedge was effective in offsetting the changes in the expected cash flows under the firm commitment that were due to foreign exchange risk.

	20X1 **CU**	**20X0** **CU**
Accumulated gains on hedging instruments in effective hedges of forecast transactions recognised in other comprehensive income at the beginning of the year	24,475	–
Gains arising in the year on hedging instruments recognised in other comprehensive income in the year	100,525[d]	24,475
	125,000	24,475
Reclassified from other comprehensive income to profit or loss in the year	(4,167)[e]	–
Accumulated gains on hedging instruments in effective hedges of forecast transactions recognised in other comprehensive income at the end of the year	**120,833**	**24,475**

On 31 December 20X0, the fair value of the foreign currency forward contract was CU24,475.

At 1 July 20X1, when the forward contract matured, CU125,000 in gains on the forward contract had been recognised in other comprehensive income. These gains are being reclassified to profit or loss in the same periods in which the specialised equipment affects profit or loss through depreciation and, if relevant, impairment. Depreciation of the equipment commenced on 1 July 20X1 and will continue over the equipment's 15-year estimated useful life. At 31 December 20X1 the amount of gains still to be reclassified to profit or loss totals CU120,833.

In 20X1 and 20X0 the company had no other hedging relationships.

The calculations and explanatory notes (a)–(e) do not form part of the proposed disclosures:

(a) Had there been any hedge ineffectiveness, it would have been included in Profit for the year. However, in this example there was no hedge ineffectiveness (see Case Study 3).

(b) Change in fair value of the forward contract from 1 November 20X0 to 31 December 20X0 minus hedge ineffectiveness = CU24,475 (see Case Study 3).

(c) CU96,358 = the change in fair value between 1 January 20X1 and 1 July 20X1 (CU100,525—see note (d)) minus the amount reclassified to profit or loss to match with six months' depreciation (CU4,167—see note (e)).

(d) Change in fair value between 1 January 20X1 and 1 July 20X1 = CU100,525 (see Case Study 3, note (a)).

(e) Reclassification of cumulative exchange gain to match with six months' depreciation = CU4,167 (see Case Study 3, note (f)).

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