Technical Advisory Group
Issue Paper

AGENDA ITEM: TAGED09-03
10 January 2023 – Online

Section 11 (Financial instruments), Section 21 (Provisions and contingencies) and Section 22 (Liabilities and equity)

Summary	This paper provides TAG members with the proposed approach to updating Sections 11, 21 and 22, which are being updated to align with changes to other Sections and not fundamentally reviewed.
Purpose/Objective of the paper	To allow TAG members to consider the consequential impact of changes to other Sections and any other emerging issues.
Other supporting items	None
Prepared by	Karen Sanderson
Actions for this meeting	**Comment and advise** on: (i) the proposed inclusion of a new category in financial instruments of grant prepayment assets and grant payment liabilities (ii) the treatment in the changes in fair value of hedging and other financial instruments (iii) the definition of which financial instruments can be classified as equity

Technical Advisory Group

Section 11 (Financial instruments), Section 21 (Provisions and contingencies) and Section 22 (Liabilities and equity)

1. Background

1.1 In line with responses to the Consultation Paper it was agreed to prioritise a limited number of topics for inclusion in the first edition of INPAG. Following discussions with the TAG it was agreed that other topics in the *IFRS for* SMEs Accounting Standard would be updated to align with the terminology being used in the remainder of INPAG.

1.2 As INPAG is being developed there are other consequential amendments that may need to be made that go beyond changes to terminology previously discussed. A limited number of changes are therefore proposed to ensure that INPAG is cohesive. These consequential amendments do not constitute a full review of the text in these topic areas.

2. Financial instruments

2.1 Section 11 has been updated to reflect NPO related terminology and the scope of the financial statements. It has also been updated as a consequence of the guidance proposed in the new Section 24A on grant expenses.

2.2 A new paragraph has been inserted (G11.17):

For grant prepayment assets and grant payment liabilities that comprise resources other than cash, an NPO shall measure those resources initially at the total carrying amount of the resources which have been transferred or which the grant providing NPO is obligated to transfer. For grant prepayment assets and grant payment liabilities that relate to cash then the requirements of G11.16 apply.

that addresses non-cash grant prepayment assets and grant liability payments. Consequential amendments have also been made to paragraphs G11.12, G11.16, G11.20 and G11.26 for all grant prepayment assets and grant payments liabilities. In addition a new disclosure of grant prepayment assets and grant payments liabilities is proposed in G11.52.

2.3 These amendments reflect the proposals in TAGED09-02 *Grant expenses.* Any changes made to the proposals for grant expenses may require consequential amendments. The changes proposed are intended to provide guidance on the recognition, measurement and disclosure of grant prepayment assets and grant payments liabilities.

2.4 Paragraphs G11.81 and G11.83 have been updated to require that changes in the fair value of hedging instruments are recognised in the Statement of Changes in Net Assets until the instrument is discontinued at which point any gains or losses are reclassified to surplus or deficit. This reflects previous discussion on which items appear in which financial statement. The proposed change therefore reflects the intent on how the Statement of Income and Expenses and the Statement of Changes in Net Assets are used.

2.5 It should be noted that in paragraph G11.18, generally changes in the fair value of financial instruments are required to be recognised through surplus or deficit. It is proposed to retain the requirements of the *IFRS for SMEs* Accounting Standard, until such time as this Section is fully reviewed.

Question 1: Do TAG members have any comments on the proposals for grant prepayment assets and grant payments liabilities as a consequence of the drafting of INPAG Section 24A *Grant Expenses?*

Question 2: Do TAG members have any comments on the proposed approach taken to the recognition, measurement and presentation of changes to the fair value of financial instruments?

3. Provisions and contingencies

3.1 Section 21 on Provisions and contingencies is proposed to be incorporated into INPAG with only updates to terminology. There may, however, be further consequential changes in Paragraph G21.1 depending on the decisions taken regarding the approach to developing guidance for revenue.

Question 3: Do TAG members have any comments on the draft of Section 21?

4. Liabilities and equity

4.1 A number of amendments are proposed to Section 22 *Liabilities and Equity*. These are mostly due to changes to terminology and due to consequential changes as a result of proposed amendments to other sections. For example proposed changes to Section 26 *Share-based payments* and Section 28 *Employee benefits* as set out in TAGED09-04 are included in the drafting of this Section.

4.2 Paragraph G22.5 is concerned with the classification of financial instruments as equity. This paragraph has been amended to reflect that to meet the definition of equity it is not just 'representing the residual interest in the net assets', but an entitlement to those net assets.

4.3 In G22.5 (a) (i) the paragraph has been amended to reflect that the holder of an equity claim may not be entitled to a 'pro rata share' of net assets, but may be entitled to specific assets, or a share of net assets that is not a 'pro rata' share. Paragraph Other paragraphs are also amended to reflect that an entitlement may not relate to a pro rata share of net assets.

4.4 In G22.5 (a) (i) the paragraph has also been amended to reflect that the entitlement to a share of net assets or specific net assets is not only due to liquidation, but may also be linked to the NPO ceasing to be an NPO. It is proposed to make this amendment for circumstances where equity is only provided where the entity is pursuing certain activities, which would be expected to be linked to the characteristics of an NPO.

4.5 It is also proposed to remove a requirement for returns as part of the classification of a financial instrument as equity. Paragraph 22.4 (a) (v) of the *IFRS for SMEs* Accounting Standard requires that for a financial instrument to be classified as equity the total expected cash flows attributable to the instrument over its life are based on profit or loss or on a change in net assets. The holders of equity claims in NPOs are unlikely to be motivated by the returns that can be earned from their equity interest but more in the use of that equity interest in furthering the purposes of the NPO. As a consequence it is proposed to delete this requirement.

4.6 Paragraph G22.13 which relates to the capitalisation or bonus issue of shared has been reduced to reflect that this is unlikely to arise.

Question 4: Do TAG members agree that to be equity the holders of equity claims must have an entitlement?

Question 5: Do the TAG members agree with the proposed amendments to the requirements for classification of a financial instrument as equity?

Question 6: Do TAG member have any comments other comments on the draft of Section 22?

5. Implementation Guidance

5.1 The *IFRS for SMEs* Accounting Standard includes illustrative examples in a number of Sections, but does not have a separate volume for implementation guidance or examples. To provide consistency with the section of INPAG that have been fully updated, it is proposed that examples are removed from the core INPAG text and instead included in the Implementation Guidance.

5.2 Section 11 *Financial Instruments* includes the examples of financial assets and liabilities and use of the effective interest method from the *IFRS for SMEs* Accounting Standard with updates to reflect the core text.. Examples could also be added of grant prepayment assets and grant liability payments, subject to TAG discussions.

5.3 Section 21 *Provisions and contingencies* includes a number of examples of when to make a provision. These examples come exclusively from the *IFRS for SMEs* Accounting Standard with amendments made as appropriate. There is an example on warranties. It is proposed to assess the need for this example as the text of the revenue section is developed.

5.4 This is an example of a convertible bond in Section 22 *Liabilities and equities* of the *IFRS for SMEs* Accounting Standard. It is not proposed to bring this into INPAG.

Question 7: Do TAG members agree that all examples should be in the Implementation Guidance?

Question 8: Do TAG members have any comments on the examples provided?

6. Next steps

6.1 The authoritative guidance will be amended to reflect TAG member feedback. Unless otherwise requested, and only further consequential amendments will be brought to the February 2023. A Basis for Conclusions will only be developed where consequential amendments are made and not for other changes to terminology.

January 2023

Notice

INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

Annex A

Section 11 (Financial instruments), Section 21 (Provisions and contingencies) and Section 22 (Liabilities and equity)

Section 11 - *Financial Instruments*

Scope of this section

G11.1 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 NPOs. 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, even NPOs with only basic financial instruments shall consider the scope of Part II of Section 11 to ensure they are exempt.

Part I of Section 11

Basic Financial Instruments

Introduction to Part I of Section 11

G11.2 A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or **equity** instrument of another entity.

G11.3 Part I of Section 11 requires an amortised cost model for all basic financial instruments except for issued **financial guarantee contracts**, and 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.

G11.4 Basic financial instruments within the scope of Part I of Section 11 are those that satisfy the conditions in paragraph G11.7. 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;
(g) commitments to receive a loan if the commitment cannot be net settled in cash; and.
(h) issued financial guarantee contracts.

G11.5 Examples of financial instruments that do not normally satisfy the conditions in paragraph G11.7, 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; and
(e) commitments to receive a loan if the commitment can be net settled in cash.

Scope of Part I of Section 11

G11.6 Part I of Section 11 applies to all financial instruments meeting the conditions of paragraph G11.7 except for the following:
(a) investments in **controlled entities** 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 NPO's own equity, including the equity component of **compound financial instruments** issued by the NPO (see Section 22 *Liabilities and Equity*).
(c) **leases**, to which Section 20 *Leases* or paragraph G11.61(f) apply. However, the **derecognition** requirements in paragraphs G11.44–G11.49 apply to the derecognition of lease receivables recognised by a lessor and lease payables recognised by a lessee, and the impairment requirements in paragraphs G11.32–G11.43 apply to lease receivables recognised by a lessor.
(d) employers' rights and obligations under **employee benefit** plans, to which Section 28 *Employee Benefits* applies.
(e) financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 *Share-based Payment* applies.
(f) reimbursement **assets** that are accounted for in accordance with Section 21 *Provisions and Contingencies* (see paragraph G21.9).
(g) rights and obligations within the scope of Section 23 *Revenue* that are financial instruments, except for receivables and those that Section 23 specifies are accounted for in accordance with this section.

Basic financial instruments

G11.7 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 G11.8 and/or paragraph G11.9;

(c) a commitment to receive a loan that:

(i) cannot be settled net in cash; and

(ii) when the commitment is executed, is expected to meet the conditions in paragraph G11.8.

(d) an investment in non-convertible preference shares and non-puttable **ordinary shares** ordinary shares or preference shares; and.

(e) issued financial guarantee contracts.

G11.8 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 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).

G11.9 A debt instrument that does not meet all of the conditions in paragraph G11.8(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 principal amount outstanding. 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 this assessment, '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.

G11.10 Examples of debt instruments that would normally satisfy the conditions in paragraph G11.8(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.

G11.11 An example of a debt instrument that would normally satisfy the conditions set out in paragraph G11.8(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.

G11.12 Other examples of financial instruments that would normally satisfy the conditions in paragraph G11.8 are:
(a) trade accounts and notes receivable and payable, and loans from banks or other third parties.
(b) grant prepayment assets and grant payment liabilities as defined in G24A.26-G24A.29
(c)accounts payable in a foreign currency. However, any change in the account payable because of a change in the exchange rate is recognised in **surplus or deficit** as required by paragraph 30.10.
(d) loans to or from controlled entities or associates that are due on demand.
(e) 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 G11.8).

G11.13 Examples of financial instruments that do not satisfy the conditions in paragraph G11.8 or G11.9 (and are therefore within the scope of Part II of Section 11) include:
(a) an investment in another entity's equity instruments other than nonconvertible preference shares and non-puttable ordinary and preference shares (see paragraph G11.7(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 G11.8(a);
(c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph G11.8(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.

G11.14 Reassessment of a financial instrument classified at initial recognition in accordance with paragraphs G11.7–G11.9 shall occur only if contractual terms are modified in a way that leads to the derecognition of the financial instrument.

Initial recognition of financial assets and liabilities

G11.15 An NPO shall recognise a financial asset or a financial liability only when the NPO becomes a party to the contractual provisions of the instrument.

Initial measurement

G11.16 When a financial asset or financial liability is recognised initially, unless it is a grant prepayment asset or grant payment liability, an NPO 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 surplus or deficit) unless the arrangement constitutes, in effect, a financing transaction for either the NPO (for a financial liability) or the counterparty (for a financial asset) to the arrangement. An arrangement constitutes a financing transaction if payment is deferred beyond normal business terms, for example, providing interest-free credit to a buyer for the sale of goods, or is financed at a rate of interest that is not a market rate, for example, an interest-free or below market interest rate loan made to an employee. If the arrangement constitutes a financing transaction, the NPO 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.

G11.7 For grant prepayment assets and grant payment liabilities that comprise resources other than cash, an NPO shall measure those resources initially at the total carrying amount of the resources which have been transferred or which the grant providing NPO is obligated to transfer. For grant prepayment assets and grant payment liabilities that relate to cash then the requirements of G11.16 apply.

Subsequent measurement

G11.18 At the end of each **reporting period**, an NPO shall measure financial instruments as follows, without any deduction for transaction costs the NPO may incur on sale or other disposal:

(a) debt instruments that meet the conditions in paragraph G11.7(b) shall be measured at **amortised cost** using the **effective interest method**. Paragraphs G11.20–G11.25 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 G11.26–G11.43) unless the arrangement constitutes, in effect, a financing transaction (see paragraph G11.16).

(b) commitments to receive a loan that meet the conditions in paragraph G11.7(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 surplus or deficit; and

(ii) all other such investments shall be measured at cost less impairment.

(d) issued financial guarantee contracts are measured at the higher of:

(i) the expected **credit losses** measured in accordance with paragraphs G11.33–G11.43; and

(ii) the amount initially recognised, if any, amortised on a straightline basis over the life of the guarantee.

Impairment or uncollectability must be assessed for financial assets in (a), (b) and (c)(ii). Paragraphs G11.26–G11.43 provide guidance.

G11.19 **Dividends** are recognised in surplus or deficit only when:

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

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

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

Amortised cost and effective interest method

G11.20 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 G11.16 or the total carrying amount of the resources which have been transferred or which the grant providing NPO is obligated to transfer in accordance with G11.17. Consequently, (c) does not apply to them.

G11.21 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.

G11.22 When calculating the effective interest rate, an NPO 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 expected credit losses.

G11.23 When calculating the effective interest rate, an NPO 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 NPO 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.

G11.24 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.

G11.25 If an NPO revises its estimates of payments or receipts (excluding changes in estimates of expected credit losses), the NPO 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 NPO 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 NPO shall recognise the adjustment as income or expense in surplus or deficit at the date of the revision.

Impairment of trade receivables and contract assets, grant prepayment assets and financial assets measured at cost

Recognition

G11.26 At the end of each reporting period, an NPO shall assess whether there is objective evidence of impairment of any trade receivables and **contract assets** within the scope of Section 23, any grant prepayment assets and any financial assets that are measured at cost in accordance with paragraphs G11.18(b) and G11.18(c)(ii). If there is objective evidence of impairment, the NPO shall recognise an impairment loss in surplus or deficit immediately.

G11.27 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.

G11.28 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.

G11.29 An NPO 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 NPO shall assess other financial assets for impairment either individually or grouped on the basis of similar credit risk characteristics.

Measurement

G11.30 An NPO shall measure an impairment loss as follows:
(a) for a financial asset measured at amortised cost in accordance with paragraph G11.18(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.
(b) for a financial asset measured at cost less impairment in accordance with paragraphs G11.18(b) and G11.18(c)(ii) the impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which might be zero) that the entity would receive for the asset if it were to be sold at the reporting date.

Reversal

G11.31 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 NPO 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 NPO shall recognise the amount of the reversal in surplus or deficit immediately.

Impairment of other financial assets measured at amortised cost

G11.32 At the end of each reporting period, an NPO shall recognise an allowance for expected credit losses on any financial assets measured at amortised cost in accordance with paragraph G11.18(a) that are not trade receivables or contract assets in the scope of Section 23. An entity shall recognise in surplus or deficit, as an impairment gain or loss, the amount of expected credit losses (or reversal) that is required to adjust the allowance for expected credit losses at the reporting date to the amount that is required to be recognised in accordance with paragraphs G11.33–11.43.

Measurement of expected credit losses

G11.33 An NPO shall measure expected credit losses of a financial instrument in a way that reflects:
(a) an unbiased and probability-weighted amount that is determined by evaluating alternative possible outcomes;
(b) the time value of money; and

(c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. For the purposes of this paragraph only, 'undue cost or effort' refers to the extent information shall be obtained to apply (c). It is not an undue cost or effort exemption as discussed in paragraphs G2.33–G2.36.

G11.34 Expected credit losses are a probability-weighted estimate of credit losses (that is, the present value of all cash shortfalls) over the expected life of the financial instrument. The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which an NPO is exposed to credit risk. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the NPO expects to be paid in full but later than when contractually due.

G11.35 A cash shortfall is the difference between the cash flows that are due to an NPO in accordance with the contract and the cash flows that the NPO expects to receive. The estimate of expected cash shortfalls considers the probability of a foreclosure and the cash flows that would result from it, for example, cash flows from collateralised assets.

G11.36 An NPO may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph G11.33.

G11.37 Expected credit losses on lease receivables shall be measured in a way consistent with the cash flows and the discount rate used in the measurement of the lease receivable in accordance with Section 20.

Financial guarantee contracts

G11.38 For a financial guarantee contract, the issuer is required to make payments to the holder only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls (see paragraph G11.35) are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that an NPO expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

Probability-weighted outcome

G11.39 When measuring expected credit losses, an NPO need not identify every possible scenario. However, that measurement shall reflect at least two outcomes, the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

G11.40 The average credit losses of a group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations when financial assets are individually significant—for example a loan to a related party—the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed.

Time value of money

G11.41 Expected credit losses shall be discounted to the reporting date, using the effective interest rate determined at initial recognition. If a financial instrument has a variable interest rate, expected credit losses shall be discounted using the current effective interest rate determined in accordance with paragraph G11.24.

Reasonable and supportable information

G11.42 An NPO shall use reasonable and supportable information to estimate expected credit losses. It may source data, both internally (NPO-specific data) and externally. Possible data sources include: internal historical credit-loss experience; internal ratings; the credit-loss experience of other entities; and external ratings, reports and statistics. An NPO with insufficient sources of NPO-specific data may make use of the experience of its peer group for the comparable financial instrument (or groups of financial instruments).

G11.43 Historical information is an important anchor or base from which to measure expected credit losses. However, an NPO shall adjust historical data, such as credit-loss experience, to reflect, and be directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses). In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered.

Derecognition of a financial asset

G11.44 An NPO 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 NPO transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or

(c) the NPO, 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 surplus or deficit in the period of the transfer.

G11.45 If a transfer does not result in derecognition because the NPO has retained significant risks and rewards of ownership of the transferred asset, the NPO 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 NPO shall recognise any income on the transferred asset and any expense incurred on the financial liability.

G11.46 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.

Derecognition of a financial liability

G11.47 An NPO 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.

G11.48 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 NPO 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.

G11.49 The NPO shall recognise in surplus or deficit 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.

Disclosures

G11.50 The following disclosures make reference to disclosures for financial liabilities measured at fair value through surplus or deficit. Entities that have only basic financial instruments (and therefore do not apply Part II of Section 1112) will not have any financial liabilities measured at fair value through surplus or deficit and hence will not need to provide such disclosures.

Disclosure of accounting policies for financial instruments

G11.51 In accordance with paragraph G8.5, an NPO shall disclose material accounting policy information. Information about the **measurement basis** (or bases) for financial instruments used in preparing the financial statements is expected to be material accounting policy information.

Statement of Financial Position—categories of financial assets and financial liabilities

G11.52 An NPO 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 surplus or deficit (paragraph G11.18(c)(i) and paragraphs G11.65–G11.66);

(b) financial assets that are debt instruments measured at amortised cost (paragraph G11.18(a));

(c) grant prepayment assets and grant payment liabilities measured in accordance with G11.18

(d) financial assets that are equity instruments measured at cost less impairment (paragraph G11.18(c)(ii) and paragraphs G11.65–G11.66);

(e) financial liabilities measured at fair value through surplus or deficit (paragraphs G11.65–G11.66);

(f) financial liabilities measured at amortised cost (paragraph G11.18(a)); and

(g) loan commitments measured at cost less impairment (paragraph G11.18(b)); and.

(h) issued financial guarantee contracts (paragraph G11.18(d)).

G11.53 An NPO 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 NPO).

G11.54 If a reliable measure of fair value is no longer available, or is not available without undue cost or effort when such an exemption is provided, for any financial instruments that would otherwise be required to be measured at fair value through surplus or deficit in accordance with this Guidance, the NPO 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

G11.55 If an NPO has transferred financial assets to another party in a transaction that does not qualify for derecognition (see paragraphs G11.44–G11.46), the NPO 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 NPO remains exposed; and
(c) the carrying amounts of the assets and of any associated liabilities that the NPO continues to recognise.

Collateral

G11.56 When an NPO 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.

Defaults and breaches on loans payable

G11.57 For **loans payable** recognised at the reporting date for which there is a breach of terms or a default of principal, interest, sinking fund or redemption terms that have not been remedied by the reporting date, an NPO 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.

Items of income, expense, gains or losses

G11.58 An NPO 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 surplus or deficit;
(ii) financial liabilities measured at fair value through surplus or deficit;

(iii) financial assets measured at amortised cost;
(iv) financial liabilities measured at amortised cost; and.
(v) issued financial guarantee contracts.

(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 surplus or deficit; and

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

Quantitative and qualitative information about amounts arising from expected credit losses

G11.59 An NPO shall explain the inputs, assumptions and estimation techniques used to apply the requirements in paragraphs G11.33–G11.43. For this purpose the NPO shall disclose:

(a) the basis of inputs and assumptions and the estimation techniques used to measure the expected credit losses;

(b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and

(c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

G11.60 To explain the changes in the allowance for expected credit losses and the reasons for those changes, an NPO shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the allowance, in a table. The NPO shall disclose information about the changes in the allowance for financial assets separately from those for expected credit losses on issued financial guarantee contracts.

Part II of Section 11

Other Financial Instrument Issues

Scope of Part II of Section 11

G11.61 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 **controlled entities** and, **associates** and **joint arrangement** 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 NPO's own equity, including the equity component of **compound financial instruments** issued by the NPO (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) financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 *Share-based Payment* applies.

(h) reimbursement assets that are accounted for in accordance with Section 21 *Provisions and Contingencies* (see paragraph G21.10).

G11.62 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 this section 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.

G11.63 In addition to the contracts described in paragraph G11.62, 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 NPO's expected purchase, sale or usage requirements are not financial instruments for the purposes of Section 11.

.

Initial recognition of financial assets and liabilities

G11.64 An NPO shall recognise a financial asset or a financial liability only when the NPO becomes a party to the contractual provisions of the instrument.

Initial measurement

G11.65 When a financial asset or financial liability is recognised initially, an NPO shall measure it at its **fair value**, which is normally the transaction price.

Subsequent measurement

G11.66 At the end of each **reporting period**, an NPO shall measure all financial instruments within the scope of Part II of Section 11 at fair value and recognise changes in fair value in **surplus or deficit**, except as follows:

(a) some changes in the fair value of **hedging instruments** in a designated hedging relationship are required to be recognised in **the Statement of Changes in Net Assets** by paragraph G11.81; 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.

G11.67 Dividends are recognised in surplus or deficit only when:

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

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

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

G11.68 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 surplus or deficit, 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 NPO 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.

Fair value

G11.69 An NPO shall apply the guidance on fair value in Section 12 to fair value measurements in accordance with Section 11.

G11.70 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.

Impairment of financial assets measured at cost or amortised cost

G11.71 An NPO shall apply the guidance on impairment in paragraphs G11.26–G11.43 to financial assets measured at cost less impairment in accordance with Part II of Section 11.

Derecognition of a financial asset or financial liability

G11.72 An NPO shall apply the **derecognition** requirements in paragraphs G11.44–G11.49 to financial assets and financial liabilities to which Section 11 applies.

Hedge accounting

G11.73 If specified criteria are met, an NPO 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 surplus or deficit at the same time.

G11.74 To qualify for hedge accounting, an NPO shall comply with all of the following conditions:
(a) the NPO 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 G11.75.
(c) the hedging instrument is as specified in paragraph G11.76.
(d) the NPO 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.

G11.75 This Guidance 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 NPO 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 G11.4(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 surplus or deficit. 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 surplus or deficit 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).

G11.76 This Guidance 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 G11.75 that is designated as the hedged risk;

(b) it involves a party external to the **reporting NPO** (ie external to the **group**, segment or individual NPO 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.

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

G11.77 If the conditions in paragraph G11.74 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 NPO shall:
(a) recognise the hedging instrument as an asset or liability and the change in the fair value of the hedging instrument in surplus or deficit; and
(b) recognise the change in the fair value of the hedged item related to the hedged risk in surplus or deficit and as an adjustment to the carrying amount of the hedged item.

G11.78 If the hedged risk is the fixed interest rate risk of a debt instrument measured at amortised cost, the NPO shall recognise the periodic net cash settlements on the interest rate swap that is the hedging instrument in surplus or deficit in the period in which the net settlements accrue.

G11.79 The NPO shall discontinue the hedge accounting specified in paragraph G11.77 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 G11.74; or
(c) the NPO revokes the designation.

G11.80 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 surplus or deficit using the **effective interest method** over the remaining life of the hedged item.

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

G11.81 If the conditions in paragraph G11.74 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 NPO shall recognise in the Statement of Changes in Net Assets 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 NPO shall recognise in surplus or deficit 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 the Statement of Changes in Net Assets shall be reclassified to surplus or deficit when the hedged item is recognised in surplus or deficit, subject to the requirements in paragraph G11.83. However, the cumulative amount of any exchange differences that relate to a hedge of a net investment in a foreign operation recognised in the Statement of Changes in Net Assets shall not be reclassified to surplus or deficit on disposal or partial disposal of the foreign operation.

G11.82 If the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost, the NPO shall subsequently recognise in surplus or deficit the periodic net cash settlements from the interest rate swap that is the hedging instrument in the period in which the net settlements accrue.

G11.83 The NPO shall discontinue prospectively the hedge accounting specified in paragraph G11.81 if:
(a) the hedging instrument expires or is sold or terminated;
(b) the hedge no longer meets the criteria for hedge accounting in paragraph G11.74;
(c) in a hedge of a forecast transaction, the forecast transaction is no longer highly probable; or
(d) the NPO 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 the Statement of Changes in Net Assets shall be reclassified to surplus or deficit.

Disclosures

G11.84 An NPO 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 NPO uses hedge accounting, it shall make the additional disclosures in paragraphs G11.85–G11.87.

G11.85 An NPO shall disclose the following separately for hedges of each of the four types of risks described in paragraph G11.75:
(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.

G11.86 If an NPO uses hedge accounting for a hedge of fixed interest rate risk or commodity price risk of a commodity held (paragraphs G11.77–G11.80) it shall disclose the following:
(a) the amount of the change in fair value of the hedging instrument recognised in surplus or deficit for the period; and
(b) the amount of the change in fair value of the hedged item recognised in surplus or deficit for the period.

G11.87 If an NPO 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 G11.81–G11.83), it shall disclose the following:
(a) the periods when the cash flows are expected to occur and when they are expected to affect surplus or deficit;
(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 the Statement of Changes in Net Assets during the period (paragraph G11.81);
(d) the amount that was reclassified to surplus or deficit for the period (paragraphs G11.81 and G11.83); 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 surplus or deficit for the period (paragraph G11.81).

Section 21 - *Provisions and Contingencies*

Scope of this section

G21.1 This Section applies to all **provisions** (ie liabilities of uncertain timing or amount), **contingent liabilities** and **contingent assets** except those provisions covered by other sections of this Guidance. These include provisions relating to:

(a) **leases** (Section 20 *Leases*). However, this Section deals with **operating leases** that have become onerous.

(b) **revenue** ~~from **contracts** with **customers**~~ (Section 23 ~~*Revenue from Contracts with Customers*~~). However this section deals with contracts with grant providers and customers that have become onerous.

(c) **employee benefit** obligations (Section 28 *Employee Benefits*).

(d) **income tax** (Section 29 *Income Tax*).

(e) **contingent consideration** of an **acquirer** in a **business combination** (Section 19 *Business Combinations and Goodwill*).

G21.2 The requirements in this Section do not apply to **executory contracts** unless they are **onerous contracts**. Executory contracts are contracts under which neither party has fulfilled any of its obligations or both parties have partially fulfilled their obligations to an equal extent.

G21.3 The word 'provision' is sometimes used in the context of such items as **depreciation**, impairment of **assets** and uncollectable receivables. Those are adjustments of the **carrying amounts** of assets, instead of **recognition** of liabilities, and therefore are not covered by this Section.

Initial recognition

G21.4 An NPO shall recognise a provision only when:

(a) the NPO has an obligation at the **reporting date** as a result of a past event;

(b) it is **probable** (ie more likely than not) that the NPO will be required to transfer economic benefits in settlement; and

(c) the amount of the obligation can be estimated reliably.[4]

G21.5 The NPO shall recognise the provision as a liability in the **Statement of Financial Position** and shall recognise the amount of the provision as an **expense**, unless another

[4] This section uses the term provision in a way that differs in some respects from the definition of a liability in paragraph G2.59 and the Glossary. For the purpose of this Section, a liability is a present obligation of the NPO arising from past events, the settlement of which is expected to result in an outflow from the NPO of resources embodying economic benefits.

Section of this Guidance requires the cost to be recognised as part of the cost of an asset such as **inventories** or **property, plant and equipment**.

G21.6 The condition in paragraph G21.4(a) (obligation at the reporting date as a result of a past event) means that the NPO has no realistic alternative to settling the obligation. This can happen when the NPO has a legal obligation that can be enforced by law or when the NPO has a **constructive obligation** because the past event (which may be an action of the NPO) has created valid expectations in other parties that the entity will discharge the obligation. Obligations that will arise from the NPO's future actions (ie the future conduct of its activities) do not satisfy the condition in paragraph G21.4(a), no matter how likely they are to occur and even if they are contractual. To illustrate, because of operational pressures or legal requirements, an NPO may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting safety equipment in an operational building). Because the NPO can avoid the future expenditure by its future actions, for example by changing its method of operation or selling the operational building, it has no present obligation for that future expenditure and no provision is recognised.

G21.7 A restructuring is a programme that is planned and controlled by management and materially changes either the scope of an activity undertaken by an NPO or the manner in which that activity is conducted. A constructive obligation to restructure arises only when an NPO:

(a) has a detailed formal plan for the restructuring identifying at least:

(i) the activities concerned;

(ii) the principal locations affected;

(iii) the location, function and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented.

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Initial measurement

G21.8 An NPO shall measure a provision at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount an NPO would rationally pay to settle the obligation at the end of the **reporting period** or to transfer it to a third party at that time:

(a) when the provision involves a large population of items, the estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

(b) when the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. However, even in such a case, the NPO considers other possible outcomes. When other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount than the most likely outcome.

When the effect of the time value of money is **material**, the amount of a provision shall be the **present value** of the amount expected to be required to settle the obligation. The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money. The risks specific to the liability shall be reflected either in the discount rate or in the estimation of the amounts required to settle the obligation, but not both.

G21.9 An NPO shall exclude gains from the expected disposal of assets from the measurement of a provision.

G21.10 When some or all of the amount required to settle a provision may be reimbursed by another party (for example, through an insurance claim), the NPO shall recognise the reimbursement as a separate asset only when it is virtually certain that the NPO will receive the reimbursement on settlement of the obligation. The amount recognised for the reimbursement shall not exceed the amount of the provision. The reimbursement receivable shall be presented in the Statement of Financial Position as an asset and shall not be offset against the provision. In the **Statement of Income and Expenses**, the NPO may offset any reimbursement from another party against the expense relating to the provision.

Subsequent measurement

G21.11 An NPO shall charge against a provision only those expenditures for which the provision was originally recognised.

G21.12 An NPO shall review provisions at each reporting date and adjust them to reflect the current best estimate of the amount that would be required to settle the obligation at that reporting date. Any adjustments to the amounts previously recognised shall be recognised in **surplus or deficit** unless the provision was originally recognised as part of the cost of an asset (see paragraph G21.5). When a provision is measured at the present value of the amount expected to be required to settle the obligation, the unwinding of the discount shall be recognised as a finance cost in profit or loss in the period it arises.

Contingent liabilities

G21.13 A contingent liability is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph G21.4. An NPO shall not recognise a contingent liability as a liability, except for contingent liabilities assumed in a business combination (see paragraph 19.10J). Disclosure of a contingent liability is required by paragraph G21.16 unless the possibility of an outflow of resources is remote. When an NPO is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

Contingent assets

G21.14 An NPO shall not recognise a contingent asset as an asset. Disclosure of a contingent asset is required by paragraph G21.17 when an inflow of economic benefits is probable. However, when the flow of future economic benefits to the NPO is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.

Disclosures

Disclosures about provisions

G21.15 For each class of provision, an NPO shall disclose all of the following:

(a) a reconciliation showing:

  (i) the carrying amount at the beginning and end of the period;

  (ii) additions during the period, including adjustments that result from changes in measuring the discounted amount;

  (iii) amounts charged against the provision during the period; and

  (iv) unused amounts reversed during the period.

(b) a brief description of the nature of the obligation and the expected amount and timing of any resulting payments;

(c) an indication of the uncertainties about the amount or timing of those outflows; and

(d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Comparative information for prior periods is not required.

Disclosures about contingent liabilities

G21.16 Unless the possibility of any outflow of resources in settlement is remote, an NPO shall disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, when practicable:

(a) an estimate of its financial effect, measured in accordance with paragraphs G21.8–G21.12;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

If it is **impracticable** to make one or more of these disclosures, that fact shall be stated.

Disclosures about contingent assets

G21.17 If an inflow of economic benefits is probable (more likely than not) but not virtually certain, an NPO shall disclose a description of the nature of the contingent assets at the end of the reporting period and, unless it would involve undue cost or effort, an estimate of their financial effect, measured using the principles set out in paragraphs G21.8–G21.12. If such an estimate would involve undue cost or effort, the NPO shall disclose that fact and the reasons why estimating the financial effect would involve undue cost or effort.

Prejudicial disclosures

G21.18 In extremely rare cases, disclosure of some or all of the information required by paragraphs G21.15–G21.17 can be expected to prejudice seriously the position of the NPO in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an NPO need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Section 22 - *Liabilities and Equity*

Scope of this section

G22.1 This Section establishes principles for classifying **financial instruments** as either liabilities or **equity** and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as **holders of equity claims**). Section 26 *Share-based Payment* addresses accounting for a transaction in which the NPO receives goods or services ~~(including employee services)~~ as consideration for its equity instruments ~~(including shares or share options)~~ from ~~employees and other~~ third parties acting in their capacity as providers of goods and services.

G22.2 This section shall be applied when classifying all types of financial instruments except:

(a) those interests in **controlled entities**, **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) employers' rights and obligations under **employee benefit** plans, to which Section 28 *Employee Benefits* applies.

(d) financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 applies, except that paragraphs G22.3–G22.7 shall be applied to **treasury shares** purchased, sold, issued or cancelled in connection with ~~employee share option plans, employee share purchase plans and all other~~ **share-based payment arrangements**.

Classification of a financial instrument as liability or equity

G22.3 ~~Equity is the residual interest in the **assets** of an entity after deducting all its liabilities.~~ For the purpose of this Section, a liability is a present obligation of the NPO arising from past events, the settlement of which is expected to result in an outflow from the NPO of resources embodying economic benefits. Net assets includes investments by the holders of equity claims of the NPO, plus or minus changes to those investments ~~earned~~ through ~~profitable~~ operations and retained in funds with restrictions and funds without restrictions, and minus ~~reductions to owners' investments as a result of unprofitable operations and~~ distributions to owners.

G22.4 An NPO shall classify a financial instrument as a **financial liability** or as equity in accordance with the substance of the contractual arrangement, not merely its legal form, and in accordance with the definitions of a financial liability and an equity instrument. Unless an NPO has an unconditional right to avoid delivering **cash** or another **financial asset** to settle a contractual obligation, the obligation meets the definition of a financial liability, and is classified as such, except for those instruments classified as equity instruments in accordance with paragraph G22.5.

G22.5 Some financial instruments that meet the definition of a liability are classified as equity because they provide an entitlement to the residual interest in the net assets of the NPO:

(a) 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 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. A puttable instrument that has all of the following features is classified as an equity instrument:

(i) it entitles the holder to ~~a pro rata share of~~ the NPO's net assets in the event of the NPO's liquidation or ceasing to be an NPO. This may be a share of the NPO's net assets (pro rata or otherwise) or an entitlement to specific assets. The NPO's net assets are those assets that remain after deducting all other claims on its assets.

(ii) the instrument is in the class of instruments that is subordinate to all other classes of instruments.

(iii) all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.

(iv) apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the NPO, and it is not a contract that will or may be settled in the NPO's own equity instruments.

~~(v) the total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the **surplus or deficit**, the change in the recognised net assets or the change in the **fair value** of the recognised and unrecognised net assets of the NPO over the life of the instrument (excluding any effects of the instrument).~~

(b) instruments, or components of instruments, that are subordinate to all other classes of instruments are classified as equity if they impose on the NPO an obligation to deliver to another party ~~a pro rata share of the~~ specific assets or a share of net assets (pro rata or otherwise) of the NPO only on liquidation or ceasing to be an NPO.

G22.6 The following are examples of instruments that are classified as liabilities instead of equity:

(a) an instrument is classified as a liability if the distribution of net assets on liquidation or on ceasing to be an NPO is subject to a maximum amount (a ceiling). For example, ~~if on liquidation~~ the holders of the instrument receive a pro rata share of the net assets, but this amount is limited to a ceiling and the excess net assets are distributed to another NPO or the government, the instrument is not classified as equity.

(b) a puttable instrument is classified as equity if, when the put option is exercised, the holder receives ~~a pro rata share of the~~ a specific asset or share of net assets (pro rata or otherwise) of the NPO measured in accordance with this Guidance. However, if the holder is entitled to an amount measured on some other basis (such as local GAAP), the instrument is classified as a liability.

(c) an instrument is classified as a liability if it obliges the NPO to make payments to the holder before liquidation or on ceasing to be an NPO, such as a mandatory distribution.

(d) a puttable instrument that is classified as equity in a controlled entity's **financial statements** is classified as a liability in the controlling NPO's consolidated financial statements.

(e) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

G22.7 Members' shares in co-operative NPOs and similar instruments are equity if:

(a) the NPO has an unconditional right to refuse redemption of the members' shares; or

(b) redemption is unconditionally prohibited by local law, regulation or the entity's governing charter.

Original issue of shares or other equity instruments

G22.8 An NPO shall recognise the issue of shares or other equity instruments as equity when it issues those instruments and another party is obliged to provide cash or other resources to the NPO in exchange for the instruments:

(a) if the equity instruments are issued before the NPO receives the cash or other resources, the NPO shall present the amount receivable as an offset to equity in its **Statement of Financial Position**, not as an asset;

(b) if the NPO receives the cash or other resources before the equity instruments are issued, and the NPO cannot be required to repay the cash or other resources received, the NPO shall recognise the corresponding increase in equity to the extent of consideration received; and

(c) to the extent that the equity instruments have been subscribed for but not issued, and the NPO has not yet received the cash or other resources, the NPO shall not recognise an increase in equity.

G22.9 An NPO shall measure equity instruments, other than those issued as part of a business combination or those accounted for in accordance with paragraphs G22.14–G22.18, at the fair value of the cash or other resources received or receivable, net of **transaction costs**. If payment is deferred and the time value of money is **material**, the initial measurement shall be on a **present value** basis.

G22.10 An NPO shall account for the transaction costs of an equity transaction as a deduction from equity. **Income tax** relating to the transaction costs shall be accounted for in accordance with Section 29 *Income Tax*.

G22.11 How the increase in equity arising on the issue of shares or other equity instruments is presented in the Statement of Financial Position is determined by applicable laws. For example, the par value (or other nominal value) of shares and the amount paid in excess of par value may be required to be presented separately.

Sale of options, rights and warrants

G22.12 An NPO shall apply the principles in paragraphs G22.8–G22.11 to equity issued by means of sales of options, rights, warrants and similar equity instruments.

Capitalisation or bonus issues of shares and share splits

G22.13 A capitalisation or bonus issue (sometimes referred to as a stock dividend) is the issue of new shares to shareholders in proportion to their existing holdings. ~~For example, an NPO may give its shareholders one dividend or bonus share for every five shares held.~~ A share split (sometimes referred to as a stock split) is the dividing of ~~an NPO's~~ existing shares into multiple shares. ~~For example, in a share split, each shareholder may receive one additional share for each share held.~~ In some cases, the previously outstanding shares are cancelled and replaced by new shares. Capitalisation and bonus issues and share splits do not change total equity. An NPO shall reclassify amounts within equity as required by applicable laws.

Convertible debt or similar compound financial instruments

G22.14 On issuing convertible debt or similar **compound financial instruments** that contain both a liability and an equity component, an NPO shall allocate the proceeds between the liability component and the equity component. To make the allocation, the NPO shall first determine the amount of the liability component as the fair value of a similar liability that does not have a conversion feature or similar associated equity component. The NPO shall allocate the residual amount as the equity component. Transaction costs shall be allocated between the debt component and the equity component on the basis of their relative fair values.

G22.15 The NPO shall not revise the allocation in a subsequent period.

G22.16 In periods after the instruments were issued, the NPO shall account for the liability component as follows:

(a) in accordance with Part I of Section 11 *Basic Financial Instruments* if the liability component meets the conditions in paragraph G11.8. In these cases, the entity shall systematically recognise any difference between the liability component and the principal amount payable at maturity as additional interest **expense** using the **effective interest method** (see paragraphs G11.20–G11.25).

(b) in accordance with Part II of Section 11 *Other Financial Instrument Issues* if the liability component does not meet the conditions in paragraph G11.8.

Extinguishing financial liabilities with equity instruments

G22.17 An NPO may renegotiate the terms of a financial liability with a creditor of the NPO with the result that the NPO extinguishes the liability fully or partially by issuing equity instruments to the creditor. Issuing equity instruments constitutes consideration paid in accordance with paragraph G11.49. An NPO shall measure the equity instruments issued at their fair value. However, if the fair value of the equity instruments issued cannot be measured reliably without undue cost or effort, the equity instruments shall be measured at the fair value of the financial liability extinguished. An NPO shall derecognise the financial liability, or part of the financial liability, in accordance with paragraphs G11.47–G11.49.

G22.18 If part of the consideration paid relates to a modification of the terms of the remaining part of the liability, the NPO shall allocate the consideration paid between the part of the liability extinguished and the part that remains outstanding. This allocation should be made on a reasonable basis. If the remaining liability has been substantially modified, the NPO shall account for the modification as the extinguishment of the original liability and the **recognition** of a new liability as required by paragraph G11.48.

G22.19 An NPO shall not apply paragraphs G22.17–G22.18 to transactions in situations in which:

(a) the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder;

(b) the creditor and the NPO are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an capital distribution by, or contribution to, the entity; or

(c) extinguishing the financial liability by issuing equity instruments is in accordance with the original terms of the financial liability (see paragraphs G22.14–G22.16).

Treasury shares

G22.20 Treasury shares are the equity instruments of an NPO that have been issued and subsequently reacquired by the NPO. An NPO shall deduct from equity the fair value of the consideration given for the treasury shares. The NPO shall not recognise a gain or loss in surplus or deficit on the purchase, sale, issue or cancellation of treasury shares.

Distributions to owners

G22.21 An NPO shall reduce equity for the amount of distributions to its holders of equity claims (holders of its equity instruments). Income tax relating to distributions to holders of equity claims shall be accounted for in accordance with Section 29.

G22.22 Sometimes an NPO distributes assets other than cash to its holders of equity claims ('non-cash distributions'). When an NPO declares such a distribution and has an obligation to distribute non-cash assets to its holders of equity claims, it shall recognise a liability. It shall measure the liability at the fair value of the assets to be distributed unless it meets the conditions in paragraph G22.23. At the end of each **reporting period** and at the date of settlement, the NPO shall review and adjust the **carrying amount** of the capital distribution payable to reflect changes in the fair value of the assets to be distributed, with any changes recognised in equity as adjustments to the amount of the distribution. When an NPO settles the capital distribution payable, it shall recognise in surplus or deficit any difference between the carrying amount of the assets distributed and the carrying amount of the capital distribution payable.

G22.23 If the fair value of the assets to be distributed cannot be measured reliably without undue cost or effort, the liability shall be measured at the carrying amount of the assets to be distributed. If prior to settlement the fair value of the assets to be distributed can be measured reliably without undue cost or effort, the liability is remeasured at fair value with a corresponding adjustment made to the amount of the distribution and accounted for in accordance with paragraph G22.22.

G22.24 Paragraphs G22.22–G22.23 do not apply to the distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution. This exclusion applies to the separate, individual and **consolidated financial statements** of an NPO that makes the distribution.

Disclosures

G22.25 If the fair value of the assets to be distributed as described in paragraphs G22.22–G22.23 cannot be measured reliably without undue cost or effort, the NPO shall disclose that fact and the reasons why a reliable fair value measurement would involve undue cost or effort.

INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

Annex B

Implementation Guidance

Section 11 – *Financial instruments*

Illustrative examples

Examples—financial assets

1 For a long-term loan made to another entity, a receivable is recognised at the present value of cash receivable (including interest payments and repayment of principal) from that entity.
2 For goods sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that entity, which is normally the invoice price.
3 For an item sold to a customer on two-year interest-free credit, a receivable is recognised at the current cash sale price for that item. If the current cash sale price is not known, it may be estimated as the present value of the cash receivable discounted using the prevailing market rate(s) of interest for a similar receivable.
4 For a cash purchase of another entity's ordinary shares, the investment is recognised at the amount of cash paid to acquire the shares.
5 For resources (cash or other assets) transferred in advance of the satisfaction of compliance obligations, a grant prepayment asset is recognised at the undiscounted amount of cash transferred or the total carrying amount of the assets transferred if it fails to meet its compliance obligations, which is normally the amount of grant allocated to the compliance obligations as required by Section 24A *Grant expenses*.

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.
3 For amounts owed to grant recipients because a compliance obligation has been met, a grant payment liability is recognised at the undiscounted amount of cash to be transferred or the total carrying amount of the assets to be transferred if it fails to meet its compliance obligations, which is normally the amount of grant allocated to the compliance obligations as required by Section 24A *Grant expenses.*
3 For a financial guarantee contract issued, for example, to a third party on behalf of a related party of the entity, a liability is recognised initially at the premium received plus the present value of any future premium payments receivable, if any.

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

On 1 January 20X0, an NPO acquires a bond for CU900, incurring transaction costs of CU50.(a) 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 CU1100 on 31 December 20X4.

Year	Carrying amount at beginning of period** CU	Interest income at 6.9584%* CU	Cash inflow CU	Carrying amount at end of period** 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 per cent is the rate that discounts the expected cash flows on the bond to the initial carrying amount:

40 ÷ (1.069584)1 + 40 ÷ (1.069584)2 + 40 ÷ (1.069584)3 + 40 ÷ (1.069584)4 + 1,140 ÷ (1.069584) 5 = 950

**The carrying amount is shown before the allowance for expected credit losses.

(a) In this publication, monetary items are denominated in ‘currency units’ (CU).

Example—transfer that qualifies for derecognition

An NPO sells a group of its accounts receivable to a bank at less than their face amount. The NPO continues to handle collections from the debtors on behalf of the bank, including sending monthly statements, and the bank pays the NPO a market-rate fee for servicing the receivables. The NPO 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 NPO 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 NPO 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 NPO 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 NPO 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 NPO has retained the risk of slow payment or non-payment by the debtors—a significant risk with respect to receivables. Accordingly, the NPO 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 NPO continues to recognise the receivables as an asset until they are collected or written off as uncollectable.

Section 21 - *Provisions and Contingencies*

Illustrative examples

~~*This appendix accompanies, but is not part of, Section 21. It illustrates application of the requirements of Section 21 in recognising and measuring provisions.*~~

All of the entities in the examples in this appendix have 31 December as their reporting date. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets; this aspect is not dealt with in the examples. References to 'best estimate' are to the present value amount, when the effect of the time value of money is material.

Example 1 Future operating losses

21A.1 An NPO determines that it is probable that a segment of its operations will incur future operating losses for several years.

Present obligation as a result of a past obligating event—there is no past event that obliges the entity to pay out resources.

Conclusion—the NPO does not recognise a provision for future operating losses. Expected future losses do not meet the definition of a liability. The expectation of future operating losses may be an indicator that one or more assets are impaired—see Section 27 *Impairment of Assets*.

Example 2 Onerous contracts

21A.2 An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. For example, an NPO may be contractually required under an operating lease to make payments to lease an asset for which it no longer has any use.

Present obligation as a result of a past obligating event—the entity is contractually required to pay out resources for which it will not receive commensurate benefits.

Conclusion—if an entity has a contract that is onerous, the NPO recognises and measures the present obligation under the contract as a provision.

Example 3 Warranties

21A.4 A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On the basis of experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event—the obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement—probable for the warranties as a whole.

Conclusion—the NPO recognises a provision for the best estimate of the costs of making good under the warranty products sold before the reporting date.

Illustration of calculations:

In 20X0, goods are sold for CU1,000,000. Experience indicates that 90 per cent of products sold require no warranty repairs; 6 per cent of products sold require minor repairs costing 30 per cent of the sale price; and 4 per cent of products sold require major repairs or replacement costing 70 per cent of sale price. Consequently, estimated warranty costs are:

CU1,000,000 × 90% × 0	= CU0
CU1,000,000 × 6% × 30%	= CU18,000
CU1,000,000 × 4% × 70%	= CU28,000
Total	= CU46,000

The expenditures for warranty repairs and replacements for products sold in 20X0 are expected to be made 60 per cent in 20X1, 30 per cent in 20X2 and 10 per cent in 20X3, in each case at the end of the period. Because the estimated cash flows already reflect the probabilities of the cash outflows, and assuming there are no other risks or uncertainties that must be reflected, to determine the present value of those cash flows the entity uses a 'risk-free' discount rate based on government bonds with the same term as the expected cash outflows (6 per cent for one-year bonds and 7 per cent for two-year and three-year bonds). Calculation of the present value, at the end of 20X0, of the estimated cash flows related to the warranties for products sold in 20X0 is as follows:

Year		Expected cash payments (CU)	Discount rate	Discount factor	Present value (CU)

1	60% × CU46,000	27,600	6%	0.9434 (at 6% for 1 year)	26,038
2	30% × CU46,000	13,800	7%	0.8734 (at 7% for 2 years)	12,053
3	10% × CU46,000	4,600	7%	0.8163 (at 7% for 3 years)	3,755
Total					41,846

The NPO will recognise a warranty obligation of CU41,846 at the end of 20X0 for products sold in 20X0.

Example 4 Closure of a division—no implementation before end of reporting period

21A.6 On 12 December 20X0 the board of an NPO decided to close down a division. Before the end of the reporting period (31 December 20X0) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

Present obligation as a result of a past obligating event—there has been no obligating event, and so there is no obligation.

Conclusion—the NPO does not recognise a provision.

Example 5 Closure of a division—communication and implementation before end of reporting period

21A.7 On 12 December 20X0 the board of an NPO decided to close a division providing a particular service. On 20 December 20X0 a detailed plan for closing the division was agreed by the board, letters were sent to service recipients warning them to seek an alternative source of support and redundancy notices were sent to the staff of the division.

Present obligation as a result of a past obligating event—the obligating event is the communication of the decision to the service recipients and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement—probable.

Conclusion—the NPO recognises a provision at 31 December 20X0 for the best estimate of the costs that would be incurred to close the division.

Example 6 Staff retraining as a result of changes in legislation

21A.8 The government introduces changes to legislation. As a result of those changes, an NPO ~~in the financial services sector~~ will need to retrain a large proportion of its administrative ~~and sales~~ workforce in order to ensure continued compliance with ~~tax~~ regulations. At the end of the reporting period, no retraining of staff has taken place.

Present obligation as a result of a past obligating event—the regulatory change does not impose an obligation on an NPO to do any retraining. An obligating event for recognising a provision (the retraining itself) has not taken place.

Conclusion—the NPO does not recognise a provision.

Example 7 A court case

21A.9 A service recipient has sued NPO X, seeking damages for injury the service recipient allegedly sustained from using the services provided by NPO X. NPO X disputes liability on grounds that the service recipient did not follow directions provided. Up to the date the board authorised the financial statements for the year to 31 December 20X1 for issue, the NPO's lawyers advise that it is probable that the NPO will not be found liable. However, when the NPO prepares the financial statements for the year to 31 December 20X2, its lawyers advise that, owing to developments in the case, it is now probable that the NPO will be found liable:

(a) at 31 December 20X1

Present obligation as a result of a past obligating event—on the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion—no provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) at 31 December 20X2

Present obligation as a result of a past obligating event—on the basis of the evidence available, there is a present obligation. The obligating event is the provision of the service to the service recipient.

An outflow of resources embodying economic benefits in settlement—probable.

Conclusion—a provision is recognised at the best estimate of the amount to settle the obligation, and the expense is recognised in profit or loss. It is not a correction of an error in 20X1 because, on the basis of the evidence available when the 20X1 financial statements were approved, a provision should not have been recognised at that time.