11. Accounting for financial assets and financial liabilities

Introduction

11.1. All charities are likely to have financial assets and financial liabilities. A financial asset represents financial resources available to the charity and examples include financial investments in shares or bonds, debtors and cash. A financial liability is a financial claim on the charity's resources and examples include loans, creditors and legal or constructive obligations, including provisions for grants payable.

11.2. FRS 102 uses the term 'financial instruments' to include both financial assets and financial liabilities. Charities should refer to sections 11 and 12 of FRS 102 for more information.

11.3. This module deals with the recognition and measurement of financial assets and financial liabilities except for those detailed below which are covered by other SORP modules and by FRS 102:

- investments in subsidiaries, associates and joint ventures;
- leases; and
- employers' rights and obligations under employee benefit plans.

11.4. Table 7 lists the common basic financial instruments and the measurement bases that charities must use. Where FRS 102 uses different terminology, which is based on International Financial Reporting Standards (IFRS), this is noted (in brackets).

11.5. Concessionary loans made by charities to further their charitable aims are financial instruments.

11.6. This module sets out:

- how all charities account for basic financial instruments;
- the accounting treatment for transactions involving extended credit terms;
- how to identify a basic financial instrument under FRS 102;
- subsequent measurement of financial assets and financial liabilities;
- impairment of financial assets;
- accounting for concessionary loans made or received;
- accounting for financial assets and financial liabilities which do not meet the FRS 102 definition of basic financial instruments;
- examples of 'other financial instruments'; and
- disclosures to be made in the notes to the accounts.

Table 7: Common basic financial instruments

Financial instrument	Measurement on initial recognition
Cash	Cash held
Debtors – including trade debtors and loans receivable (trade accounts and notes receivable)	Settlement amount after any trade discounts (provided normal credit terms apply) or amount advanced by the charity
Creditors – including trade creditors and loans payable (trade accounts and notes payable)	Settlement amount after any trade discounts (provided normal credit terms apply) or amount advanced to the charity
Overdraft (loan payable on demand)	Amount of the overdraft facility drawn down
Qualifying long-term loans (that meet the debt instrument criteria in FRS 102)	Amount of principal advanced less material arrangement or similar fees
Bank deposit	Cash amount of deposit
Investment in a non-derivative instrument that is equity of the issuer (e.g. most ordinary shares and certain preference shares that are free of any derivative or conditional element which could affect their market value or the charity's right to the shareholding)	Transaction price (cost)
Loans advanced by the charity on market terms (that meet the debt instrument criteria in FRS 102)	Amount of principal advanced

How all charities account for basic financial instruments

11.7. Charities preparing accounts normally measure a basic financial asset or basic financial liability on its initial recognition at the amount receivable or payable adjusted for any related transaction costs. However, if initially measured at fair value, transaction costs are not included in the measurement of financial assets or liabilities; instead, the transaction costs are treated as an expense. If extended credit is offered, the accounting treatment depends on those extended credit terms.

11.8. Examples of basic financial instruments include:

- A qualifying long-term loan received from a bank bearing a market rate of interest which meets the qualifying criteria set out in section 11 of FRS 102. It is recognised at its transaction value, which is normally the principal amount advanced.
- A trade debtor (current asset) for goods sold to a customer is initially measured at the cash receivable, which is normally the invoice price after allowing for any applicable trade discounts or volume discounts, provided settlement is on normal payment terms and settlement is due within 12 months of the invoice date.

11.9. If an arrangement fee is charged on a loan made to the charity and it is material, it must be treated as a deduction from the amount of principal advanced. This is because the amount of principal advanced is effectively reduced by the arrangement fee charged. The effect of this accounting treatment is to treat the arrangement fee as a component of the finance charge. The effective interest rate on the loan must be calculated to reflect the arrangement fee being amortised over the period of the loan. However, arrangement fees that are not material should be treated instead as an expense under the relevant heading(s) of the SoFA.

11.10. For more information on the effective interest method, refer to section 11 of FRS 102.

The accounting treatment for transactions involving extended credit terms

11.11. Where credit is offered by, or to, the charity on normal credit terms, the resulting debtor or creditor must be measured at the invoice price less any trade discounts. However, where credit terms are offered beyond normal credit terms and settlement is extended for at least 12 months after the invoice date, then the financing element must be separately identified and included under the relevant heading(s) of the SoFA.

11.12. The financing element is the difference between the settlement amount and the present value of that amount. The calculation of the present value of the settlement amount requires the identification of the timing and amount of future payment(s) due and then discounting these amounts at a market rate of interest for a similar debt instrument as determined at initial recognition having adjusted for transaction costs. A similar debt instrument may be an unsecured loan of an amount equivalent to the settlement value over a comparable time period. The unwinding of the discount is shown as a financing transaction (interest receivable or interest payable as appropriate).

11.13. For more information on calculating present value, refer to section 11 of FRS 102.

How to identify a basic financial instrument under FRS 102

11.14. FRS 102 distinguishes basic financial instruments from other financial instruments. The simpler recognition and measurement requirements apply only to basic financial instruments.

11.15. If a charity has a type of financial asset or financial liability which is not listed in the table of common basic financial instruments, it must refer to the detailed criteria set out in section 11 of FRS 102 to establish its accounting treatment.

11.16. A non-exchange transaction such as a gift or a grant is not a financial instrument because it is non-contractual in nature. For commitments resulting from non-exchange transactions where settlement is delayed and the effect of the time value of money is material, the transaction is recognised at the present value of the likely settlement amount.

Subsequent measurement of financial assets and financial liabilities

11.17. The subsequent measurement of financial assets and financial liabilities depends on their nature and settlement dates. The carrying amount must be calculated without any deduction for transaction costs that may be incurred on sale or disposal.

For example:

- Current assets and current liabilities must be measured at the cash or other consideration expected to be paid or received and not discounted.
- Debt instruments, for example a bank loan, must be measured at amortised cost using the effective interest method.
- Investments in shares which can be publicly traded must be measured at fair value (market value).
- Investments in shares which cannot be publicly traded must be measured at cost less impairment if fair value cannot be established using a valuation technique.

11.18. Charities that make concessionary loans or hold other financial assets or liabilities or are planning to acquire such assets or assume such liabilities must refer to the information contained in the sections that follow. More complex arrangements that charities may enter into include advance fee schemes and contracts or options to buy or sell foreign currency and 'derivatives'.

11.19. A derivative is a financial instrument or contract, the value of which changes in response to a change in a specified financial variable (for example, the interest rate) or non-financial variable (for example, tonnage shipped); it requires no or little initial investment and it is settled at a future date.

Impairment of financial assets

11.20. Financial assets measured at cost or amortised cost must be reviewed for impairment at each reporting date. A financial asset is impaired when its recoverable amount is less than its carrying amount. The charge for impairment is taken to the appropriate heading(s) in the SoFA under which the initial gain was recognised. For example, a bad debt would be charged against the income stream that is suffering the bad debt, while a downward adjustment of a previous revaluation of a fixed asset investment would be charged to gains and losses on investments within the SoFA. For information about the indicators of impairment and for more information on accounting for the impairment of financial assets, refer to section 11 of FRS 102.

Accounting for concessionary loans made or received

11.21. Concessionary loans are those loans made or received by a charity to further its purposes and any interest charged is below the prevailing market rates. See the SORP module 'Accounting for social investments' for the accounting treatments for concessionary loans.

Accounting for financial assets and financial liabilities which do not meet the FRS 102 definition of basic financial instruments

11.22. The accounting treatment for basic financial instruments is available only for financial assets and financial liabilities that fall within the definition set out in section 11 of FRS 102. The accounting treatment of other financial assets and financial liabilities requires a more complex accounting approach, as set out in section 12 of FRS 102.

11.23. This category of 'other financial instruments' includes derivatives such as:

- interest rate swaps that do not meet the definition of a basic financial instrument; and
- options and forward contracts.

11.24. Other financial instruments must be both initially recognised and then subsequently measured at fair value.

11.25. Section 12 of FRS 102 explains what is meant by the term 'hedge accounting' and the criteria that must be met to apply hedge accounting and the accounting treatment to be followed for hedging transactions.

11.26. Charities using hedge accounting must recognise the change in the fair value of the instrument in the 'other recognised gains and losses' section of the SoFA until such time as the instrument is realised or the hedging relationship ends. The gain or loss is then reclassified and shown under the relevant income or expenditure heading(s) of the SoFA.

Examples of other financial instruments

Advance fee schemes

11.27. Advance fee arrangements can take several forms and the accounting treatment will depend on the substance of the arrangement. Examples include:

- A simple discount is offered by the charity on the prevailing fee rates payable in return for payment in advance. The advance payment must be treated as deferred income until the criteria for income recognition are met.
- Interest is paid by the charity on the advance, in which case the transaction is in substance a loan and is classed as a basic financial instrument. The financing cost is the interest paid and this must be treated as an interest expense. (If the interest rate paid is below the market rate for an equivalent loan, then the loan may qualify for treatment as a concessionary loan.)
- The charity offers a fixed price or a guarantee to cap the amount of fees that might otherwise be payable in return for a fixed payment that buys two or more years of services from the charity in advance. In this case, the customer avoids having to pay any inflation increases. The cost to the charity is the revenue foregone from fee increases, in exchange for which the charity receives the cash-flow advantage of the lump sum prepaid. This is a type of 'other financial instrument' where the financing cost is not an interest rate but is the financial effect of the fee increase foregone spread over the term of the arrangement expressed as a discount rate.

Foreign exchange contracts and options

11.28. A contract for purchasing foreign exchange is a contract to buy an amount of foreign currency at an agreed rate at a future date. The transaction cost of entering into the contract is treated as an expense. The contract itself is a financial instrument.

11.29. Where the contract is to manage an exchange risk associated with a liability such as a known purchase or a grant payment, the charity may opt to treat it as a hedging transaction. If it is intended to treat the contract as a hedging transaction, then charities must refer to section 12 of FRS 102 for the criteria for a hedging transaction.

11.30. If the contract is not classed as a hedging transaction at its inception, the gain or loss on the contract at the reporting date is taken to the relevant expenditure heading(s) in the SoFA. At the end of each subsequent reporting period or when the contract is fulfilled, whichever is the earlier, any gain or loss not previously recognised is also taken to the SoFA.

11.31. An option for purchasing foreign exchange is an arrangement whereby, for a fee, the charity has purchased an option to buy or sell an amount of foreign currency at an agreed rate at a future date. The charity is not bound to exercise the option and if not exercised, the option lapses. The fee or premium for the option is capitalised but any separately identifiable transaction cost incurred in acquiring the option is treated as an expense. The option is subsequently measured at fair value.

11.32. Where an option is purchased to manage an exchange risk associated with a liability such as a known purchase or a grant, the charity may opt to treat it as a hedging transaction when this treatment is permitted by section 12 of FRS 102. If a charity intends to treat an option as a hedging transaction, reference must be made to section 12 of FRS 102 for the criteria that must be met in order for the transaction to be treated as a hedging transaction.

11.33. If the option is not eligible to be treated as a hedging transaction, or if eligible is not classed as a hedging transaction at its inception, then any unrealised gain or loss at the reporting date is taken to the relevant expenditure heading(s) in the SoFA. The minimum carrying amount of an option is nil. At the end of each subsequent reporting period or when the option is exercised or expires, whichever is the earlier, the gain or loss on exercising the option or the writing off of any residual carrying amount is charged to the SoFA.

Disclosures to be made in the notes to the accounts

11.34. All charities must provide the detailed disclosure of assets and liabilities required by the SORP module 'Balance sheet'.

11.35. Charities with basic financial instruments must disclose:

- the measurement bases and the accounting policies used for financial instruments;
- the carrying amount of financial assets measured at fair value through income and expenditure (termed profit or loss in FRS 102);
- the carrying amount of financial liabilities measured at fair value through income and expenditure (termed profit or loss in FRS 102);
- information about the significance of financial instruments to the charity's financial position or performance, for example the terms and conditions of loans or the use of hedging to manage financial risk;

- for all financial assets and financial liabilities measured at fair value, the basis for determining fair value, including any assumptions applied when using a valuation technique;
- if the charity or its subsidiary has provided financial assets as a form of security, the carrying amount of the financial assets pledged as security and the terms and conditions relating to its pledge;
- the income, expense, net gains and losses, including changes in fair value, for financial assets and financial liabilities measured at fair value, and financial assets and financial liabilities measured at amortised cost;
- the total interest income and expense for financial assets and financial liabilities that are not measured at fair value; and
- the amount of any impairment loss for each class of financial asset.

11.35A. When the risks arising from financial instruments are particularly significant to the charity (for example because they are principal financial risks for the charity) additional disclosure may be required. Reference should be made to section 34 *Specialised Activities* of FRS 102 for examples of disclosure requirements for risks arising from financial instruments that may be relevant in such cases.

11.36. If the charity makes or receives a concessionary loan, reference must also be made to the SORP module 'Accounting for social investments'.

11.37. If the charity defaults on the terms of a loan, refer to section 11 of FRS 102 for the disclosures required.

11.38. Where financial instruments are measured at fair value, refer to section 11 of FRS 102 for any applicable disclosures relating to credit risk and the nature of the instrument.

11.39. Where a financial asset which does not qualify for de-recognition has been transferred to a third party, refer to section 11 of FRS 102 for disclosures.

11.40. For other financial instruments, refer to section 12 of FRS 102 for the additional disclosures required for hedge accounting.