11. Accounting for financial assets and financial liabilities

Introduction

11.1. The reporting tiers applied for module 11 are as specified in the table below.

Table 11.1A: Tiered reporting requirements for module 11

All tiers	The requirements of financial assets and financial liabilities in this module apply fully to all charities.

11.2. 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 contractual claim on the charity's resources. Examples include loans, trade creditors, and other liabilities arising from contracts to deliver cash or other financial assets.

11.3. FRS 102 uses the term '**financial instruments'** to include both financial assets and financial liabilities. Charities must refer to Sections 11 and 12 of FRS 102 for more detailed prescriptions on financial instruments to accompany this SORP module.

11.4. 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
- lease accounting, except for the impairment of lease receivables held by a lessor (refer to paragraph 11.7(c) of FRS 102) and losses incurred on leases granted on non-standard terms. Impairment of right-of-use assets held by a lessee is addressed under Section 27 of FRS 102
- employers' rights and obligations under employee benefit plans
- rights and obligations that are financial instruments arising from exchange transactions, except for receivables from contracts with customers (refer to the SORP module 5 '*Recognition of income, including legacies, grants and contract income*' and also Section 23 of FRS 102), or where payment is deferred beyond normal business terms or is financed by the charity at a rate of interest that is not market rate, adjustments must be made to reflect the time value of money, in accordance with Section 11 of FRS 102

11.5. Table 10 lists the common basic financial instruments and the measurement bases that charities must use. Where FRS 102 uses different terminology, this is noted (in brackets).

11.6. Concessionary loans made or received by charities to further their charitable aims are financial instruments.

11.7. This module sets out:

- How to identify a basic financial instrument under FRS 102
- How all charities account for basic financial instruments
- The accounting treatment for transactions involving extended credit terms or where financed at a non-market rate of interest
- 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 description of basic financial instruments
- Examples of 'other financial instruments'
- Disclosures to be made in the notes to the accounts

How to identify a basic financial instrument under FRS 102

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

11.9. If a charity has a type of financial asset or financial liability which is not listed in Table 10 'Common basic financial instruments', it must refer to the detailed criteria set out in Section 11 of FRS 102 to establish its accounting treatment (see paragraphs 11.8 to 11.11).

11.10. A non-exchange transaction such as a donation or a grant may involve a financial instrument, for example, donated cash. However, the promise itself to make a non-exchange transaction is not a financial instrument in scope of Sections 11 and 12 of FRS 102. A charity that commits to provide resources to another entity in the form of a funding commitment must account for this transaction in accordance with section 34 of FRS 102. Where a commitment to make a non-exchange transaction exists, it must be assessed to determine whether it gives rise to a liability or provision for the charity making the funding commitment. Where settlement of a funding commitment is delayed and the effect of the time value of money is material, the liability is recognised at the present value of the resources committed. Refer to SORP module 7 '*Recognition of expenditure*' for more guidance on accounting for funding commitments.

Table 10: 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 provided settlement is on normal payment terms and is due within 12 months of the invoice date
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 provided settlement is on normal payment terms and is due within 12 months of the invoice date
Overdraft (loan payable on demand)	Amount of the overdraft facility drawn down less separately incurred transaction costs
Qualifying long-term loans, that meet the debt instrument criteria in FRS 102	Principal amount advanced less separately incurred transaction costs
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 plus transaction costs incurred by the charity

How all charities account for basic financial instruments

11.11. 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.

11.12. 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 line(s) of the statement of financial activities (SoFA).

11.13. For more information on the effective interest method, refer to Section 11 of FRS 102. Paragraphs 11.15 to 11.20 of FRS 102 provide guidance on determining amortised cost using the effective interest method.

The accounting treatment for transactions involving extended credit terms or where financed at a non-market rate of interest

11.14. 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 a period in excess of 12 months after the invoice date, or where financed at a non-market rate of interest, then the financing element must be separately identified and included under the relevant line items of the SoFA.

11.15. 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).

Subsequent measurement of financial assets and financial liabilities

11.16. 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, unless they meet a definition of a financing transaction under paragraph 11.13 of FRS 102

- debt instruments, for example a bank loan, must be measured at amortised cost using the effective interest method. Refer to paragraphs 11.15 to 11.20 of FRS 102 for guidance on determining amortised cost using the effective interest method
- investments in shares which can be publicly traded must be measured at fair value see Section 2A of FRS 102
- 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

Impairment of financial assets

11.17. Financial assets measured at cost or amortised cost must be reviewed for impairment at each reporting date.

- for an instrument measured at amortised cost, the impairment loss is the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the asset's original effective interest rate. If such a financial instrument has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract
- for an instrument measured at cost less impairment 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 charity would receive for the asset if it were to be sold at the reporting date

11.18. The charge for impairment is taken to the appropriate line in the SoFA under which any initial gain was recognised. For example, a downward adjustment of a previous revaluation of a fixed asset investment would be charged to gains and losses on investments within the SoFA.

11.19. For information about the indicators of impairment and on accounting for the impairment of financial assets see paragraphs 11.21 to 11.26 of FRS 102.

Accounting for concessionary loans made or received

11.20. Concessionary loans are those loans made or received by a charity to further its purposes. They are not repayable on demand and any interest charged is below the prevailing market rates. See SORP module 21 '*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 description of basic financial instruments

11.21. The accounting treatment for basic financial instruments is available only for financial assets and financial liabilities that fall within the description set out in Section 11 of FRS 102.

11.22. The accounting treatment of other financial assets and financial liabilities which are not basic financial instruments is set out in Section 12 of FRS 102 and requires a more complex accounting approach.

11.23. More complex arrangements that charities may enter into include advance fee schemes and contracts or options to buy or sell foreign currency and 'derivatives'.

11.24. A derivative is a financial instrument or other contract with all three of the following characteristics:

- Its value 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 an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factor
- it is settled at a future date

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

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

11.26. Other financial instruments must be both initially recognised and then subsequently measured at fair value (see paragraph 12.7 of FRS 102 for initial measurement and paragraphs 12.8 to 12.9 of FRS 102 for subsequent measurement).

11.27. A charity may apply hedge accounting if it meets the qualifying conditions. Paragraphs 12.15 to 12.25A of FRS 102 explain what is meant by the term 'hedge accounting', the qualifying conditions that must be met to apply hedge accounting and the accounting treatment to be followed for hedging transactions including treatment when they are discontinued.

11.28. Charities using hedge accounting must recognise the change in the fair value of the instrument in the 'other recognised gains and losses' section in 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 line items of the SoFA.

Examples of other financial instruments

Advance fee schemes

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

- 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
- an advance payment is received on which interest is paid by the charity on the advance, in return for a discount applied each year to the applicable academic fees due. In this 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
- a simple discount is offered by the charity on the prevailing fee rates payable in return for payment in advance for the academic year is not a financial instrument. The advance payment must be treated as deferred income until the criteria for income recognition are met

Foreign exchange contracts and options

11.30. 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.

11.31. 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 apply hedge accounting when the criteria in Section 12 of FRS 102 are met.

11.32. If the contract is not classed as a hedging instrument at its inception, the gain or loss on the contract at the reporting date is taken to the relevant expenditure line(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.

11.33. 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 treated as an 'other financial instrument' but any separately identifiable transaction cost incurred in acquiring the option is treated as an expense. The option is subsequently measured at fair value.

11.34. 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 apply hedge accounting when this treatment is permitted by Section 12 of FRS 102. If a charity intends to treat an option as a hedging instrument, 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 instrument.

11.35. If the option does not qualify for hedge accounting under Section 12 of FRS 102, or if eligible is not classed as a hedging instrument at its inception, then any unrealised gain or loss at the reporting date is taken to the relevant expenditure line(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

11.36. All charities must provide the detailed disclosure of assets and liabilities required by the SORP module 10 '*Balance sheet*'.

11.37. Charities with basic financial instruments must follow the disclosure requirements in Sections 11 and 12 of FRS 102, this includes:

- 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
- the amount of any impairment loss for each class of financial asset

11.38. 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 of FRS 102 for examples of disclosure requirements for risks arising from financial instruments that may be relevant in such cases.

11.39. If the charity makes or receives a concessionary loan, reference must also be made to the SORP module 21 ‘*Accounting for social investments*’.

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

11.41. 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.

11.42. 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.

11.43. For charities with other financial instruments applying hedge accounting, refer to Section 12 of FRS 102 for additional disclosure requirements.