

ASBG 3 FINANCIAL INSTRUMENTS

TABLE OF CONTENTS	clauses
OBJECTIVE AND BASIS FOR PREPARATION	1-2
SCOPE	3-4
DEFINITIONS	5
INITIAL RECOGNITION	6-9
SUBSEQUENT MEASUREMENT – GENERAL RULES	10-26
Measurement of Financial Assets	10-12
Measurement of Financial Liabilities	13
Financial Assets and Financial Liabilities Measured at Fair Value	14-17
Financial Assets and Financial Liabilities Measured at Amortised Cost	18-21
Impairment of Financial Assets	22-26
SUBSEQUENT MEASUREMENT – SPECIFIC AREAS	27-40
Measurement of Receivables	27-32
Measurement of Financial Investments	33-35
Measurement of Financial Liabilities	36-38
Measurement of Derivatives	39-40
DERECOGNITION	41-48
Derecognition of Financial Assets	41-43
Factoring of Receivables	44-45
Derecognition of Financial Liabilities	46-48
ACCOUNTING FOR EQUITY INSTRUMENTS	49-59
COMPARISON WITH IFRS FOR SMES	60-61

OBJECTIVE AND BASIS FOR PREPARATION

1. The objective of this Accounting Standards Board's guideline ASBG 3 "Financial Instruments" is to prescribe rules for the accounting for financial instruments in the financial statements prepared in accordance with the Estonian financial reporting standard (hereinafter also the financial statement). Estonian financial reporting standard is a body of financial reporting requirements directed at the public and based on the internationally accepted accounting and reporting principles, which principal requirements are established by the Accounting Act and which is specified by a regulation of the minister responsible for the area established on the basis of subsection 34 (4) of the Accounting Act (hereinafter *guideline of the Standards Board* or for short *ASBG*).

2. ASBG 3 is based on IFRS for SMEs, sections 11 "*Basic Financial Instruments*", 12 "*Other Financial Instruments*" and 22 "*Liabilities and Equity*" and definitions specified in section 2 "*Concepts and Pervasive Principles*" and "*Glossary of Terms*". The guideline contains references to the specific paragraphs of IFRS for SMEs that the requirements of the guideline are based on. The comparison of ASBG 3 with IFRS for SMEs is presented in clauses 60-61. In areas where ASBG 3 does not specify a particular accounting policy but that are covered by IFRS for SMEs, it is recommended to abide by the accounting policy described in IFRS for SMEs.

SCOPE

3. ***ASBG 3 "Financial Instruments" shall be applied to accounting for and reporting the following financial instruments (i.e. financial assets and liabilities and equity instruments) in the financial statements:***

- (a) cash;*
- (b) trade receivables, accrued income and other short and long-term receivables to be settled in cash;*
- (c) short and long-term investments in securities (e.g. shares, bonds, debentures, etc.), with the exception of ownership interest in subsidiaries and associates that are accounted for either using the consolidation or equity method in accordance with ASBG 11 "Business Combinations and Accounting for Subsidiaries and Associates";*
- (d) loans received, supplier payables, accrued expenses, bonds issued and other short and long-term borrowings to be settled in cash;*
- (e) derivatives (e.g. forward-, swap- and option transactions), except derivatives that meet the definition of equity instruments, for which only clauses 49-59 apply;*
- (f) shares and other equity instruments issued by an entity itself for which only clauses 49-59 apply;*
- (g) such contracts for the purchase or sale of non-financial assets that can be settled in cash or other financial instruments (accounted for as derivatives), except when they have been concluded for meeting regular purchase, sale or consumption needs of the entity.*

4. ASBG 3 shall not be applied to accounting for and reporting the following financial instruments:

- (a) investments in subsidiaries and associates that are accounted for using the consolidation or equity method (see ASBG 11 “Business Combinations and Accounting for Subsidiaries and Associates”);
- (b) financial assets and liabilities arising from lease agreements (see ASBG 9 “Accounting for Leases”);
- (c) liabilities arising from pension schemes;
- (d) contingent liabilities arising from guarantee contracts to be paid in case the debtor itself is unable to pay the debt (see ASBG 8 “Provisions, Contingent Liabilities and Contingent Assets”);
- (e) equity instruments issued by an entity itself (e.g. treasury shares of an entity, options on treasury shares, etc.), except for clauses 49-59;
- (f) financial instruments arising from insurance agreements;
- (g) contingent considerations arising in business combinations (see ASBG 11 “Business Combinations and Accounting for Subsidiaries and Associates”).

DEFINITIONS

5. *The following terms are used in this guideline with the meanings specified:*

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. (IFRS for SMEs Glossary of Terms).

A financial asset is an asset that is:

- (a) cash;
- (b) a contractual right to receive cash or other financial assets from another entity (e.g. trade receivables);
- (c) a contractual right to exchange financial assets with another party under conditions that are potentially favourable (e.g. derivatives with positive fair value);
- (d) equity instrument of another entity (e.g. investment in the shares of another entity). (IFRS for SMEs Glossary of Terms).

A financial liability is a contractual obligation:

- (a) to deliver cash or other financial assets to another entity (e.g. an obligation towards suppliers); or
- (b) to exchange financial assets with another entity under conditions that are potentially unfavourable to the entity (e.g. derivatives with negative fair value). (IFRS for SMEs Glossary of Terms).

An equity instrument is a contract that grants a right to participate in the net assets of the entity (e.g. a share or a share option). (IFRS for SMEs 22.3).

A derivative is a financial instrument:

- (a) whose value changes in response to the change in an interest rate, security price, exchange rate, price index or other similar variable;*
- (b) whose initial cost is zero or very small in comparison with other types of contracts that would be expected to have a similar response to the changes in market factors; and*
- (c) whose settlement takes place in the future.*

Examples of derivatives are forward, future, swap and option contracts.

Acquisition cost *is the fair value of cash or non-monetary consideration paid to acquire an asset at the time of its acquisition and the fair value of cash or non-monetary consideration received upon assuming a liability.*

Amortised cost *is the initial cost of a financial asset or a financial liability that has been adjusted, if necessary, with the following amounts:*

- (a) repayments of the principal (e.g. in the case of a loan received or granted);*
- (b) cumulative amortisation of a potential difference between the initial amount and the maturity amount (e.g. in the case of transaction costs of bonds or loans);*
- (c) any write-down due to impairment or uncollectibility (in the case of financial assets whose collectibility is estimated as doubtful). (IFRS for SMEs 11.15).*

The effective interest rate method *is the calculation of the amortised cost of a financial asset or a financial liability using its effective interest rate. (IFRS for SMEs 11.16).*

The effective interest rate *is the rate that discounts the estimated future cash flows arising from the financial asset or the financial liability to the carrying amount of the financial asset or the financial liability. The calculation of the effective interest rate includes all transaction costs paid or received in conjunction with the financial asset or liability, and all other premiums or discounts. (IFRS for SMEs 11.16).*

Fair value *is the amount for which an asset could be exchanged or a liability settled in a transaction between knowledgeable, willing and independent parties in an arm's length transaction. (IFRS for SMEs 2.34).*

Transaction costs *are incremental costs that are attributable to the acquisition, issue or disposal of a financial asset or a financial liability. Incremental costs are such costs that would not have been incurred if the acquisition, issue or disposal had not occurred.*

INITIAL RECOGNITION

6. *A financial asset and financial liability shall initially be recognised at cost which is the fair value of the consideration payable or receivable for the financial asset or the financial liability. Initial cost includes all transaction costs directly attributable to the acquisition of financial asset or liability, except for financial assets mentioned in clause 11 (that are recognised at fair value), in which case the transaction costs*

are neither added nor subtracted upon the calculation of initial cost. (IFRS for SMEs 11.13, 12.7).

7. If the payment for the acquired financial asset or liability is immediately made in cash, the nominal value of the amount received or paid, respectively, is considered its cost. If the payment is made after a certain longer period of time (e.g., in instalment in a year), the present value of the consideration receivable or payable, respectively, is considered to be the cost. If the payment occurs with a short-term delay (e.g., trade receivables collected in 30 days), the present value of the consideration receivable does not generally materially differ from its nominal value, and in such a case the nominal value of the consideration receivable (or payable) can be considered to be the cost. (IFRS for SMEs 11.13).

Example 1 – Recognition of long-term receivable

An entity sells an investment property for 200 000 euros (carrying amount 150 000 euros), whereas 100 000 needs to be paid immediately and 100 000 in two years. How this transaction and the resulting long-term receivable (i.e. the financial asset) should be accounted for?

As a portion of the consideration receivable will be collected after a longer period of time, the fair value, i.e. the present value of the receivable and not the nominal value of the consideration shall be considered the sale price (and the cost of the arising receivable). In calculating the present value, the discount rate used shall be the market rate of interest for similar instruments, taking into consideration specific risks relating to the entity that buys the property. Assuming, for example, that the average interest rate on loans for entities with similar maturities and risk level is approximately 10%, the present value of the 2-year receivable of 100,000 euros would be 82,645 euros ($100,000 / 1.1^2$). The difference between the nominal value and the present value shall be recognised as interest income over two years.

The accounting entry at the time of sale:

D Cash	100,000
D (Long-term) receivable	82,645
C Investment property	150,000
C Profit from sale of investment property	32,645

The accounting entry at the end of year 1:

D (Long-term) receivable	8,264
C Interest income (10% of the receivable)	8,264

The balance of the receivable at the end of year 1 is 90,909 euros and it is reclassified as short-term.

The accounting entry at the end of year 2:

D (Short-term) receivable	9,091
C Interest income (10% of the receivable)	9,091

The balance of the receivable at the end of year 2 is 100 000 euros which equals the nominal value of the consideration payable. At the end of year 2, the receivable is paid off, which is recorded as follows:

D Cash	100,000
C (Short-term) receivable	100,000

Example 2 – Recognition of short-term receivable

In accordance with the normal business practice of an entity, the payment term for its customers is 30-90 days. Although the present value of receivables arising in sales activities differs from their nominal value, the difference is relatively insignificant.

Based on the materiality principle, it is acceptable to recognise these receivables at their nominal value in the balance sheet and ignore the fact that the fair value of the receivables is actually slightly lower.

8. When a financial asset or a financial liability arises in a barter transaction in exchange for non-monetary items, the fair value of the exchanged items is considered the cost of the financial asset or the financial liability.

9. The cost includes all transaction costs (except for such financial assets and liabilities, which are recognised at fair value (see clause 11). Transaction costs are all incremental costs relating to the acquisition of a financial asset or liability (e.g. fees paid to agents and advisers, non-refundable taxes relating to the transaction and other costs directly relating to the transaction). Transaction costs neither include costs relating to the financing of the transaction nor internal administrative costs of the entity. Wages and salaries paid to the employees of the entity are considered an incremental cost relating to the transaction only if the respective part of the wages and salaries had not been paid to the employees upon non-conclusion of the transaction.

SUBSEQUENT MEASUREMENT – GENERAL RULES

Measurement of Financial Assets

10. *The following financial assets are measured at amortised cost (see clauses 18-21) (IFRS for SMEs 11.8 (a), (b), 11.9, 11.14 (a)):*

(a) trade receivables, accrued income and other short and long-term receivables (incl. loan receivables);

(b) held-to-maturity financial investments (e.g. publicly listed bonds) if the entity has opted to use the amortised cost method of accounting (otherwise such investments must be accounted for at fair value pursuant to clause 11).

An accounting method once selected for a financial instrument shall be applied consistently.

11. *The following financial assets are measured at fair value (see clauses 14-17) (except for micro entities, who shall use the method provided in clause 12 in their abridged financial statements) (IFRS for SMEs 11.14 (c), 12.8):*

- (a) short and long-term financial investments in shares and other equity instruments whose fair value can be measured reliably;**
- (b) short and long-term financial investments in publicly listed bonds and other debt instruments,**
 - i. that the entity does not intend to hold to maturity;**
 - ii. that the entity intends to hold to maturity but has opted to use the fair value method of accounting; or**
 - iii. for which the entity at the time of purchase is not certain whether it intends to hold to maturity;**
- (c) derivatives with positive fair value.**

12. The cost method (i.e. cost less any impairment) is used to account for investments in shares and other equity instruments that are not publicly traded and whose fair value cannot be measured reliably. (IFRS for SMEs 11.14 (c), 12.8)

Measurement of Financial Liabilities

13. All financial liabilities shall be measured at amortised cost in the balance sheet, except for derivatives with a negative fair value that are measured at fair value (IFRS for SMEs 11.8 (b), 11.9, 11.14, 12.8)

Financial Assets and Financial Liabilities Measured at Fair Value

14. At each reporting date, financial instruments measured at fair value shall be revalued to fair value at that moment, from which the potential transaction costs related to the realisation of the financial instrument have not been deducted. (IFRS for SMEs 11.14 (c), 12.8, 12.12)

15. Gains or losses arising from a change in the fair value shall be recognised as gains or losses in the income statement of the accounting period. (IFRS for SMEs 11.14 (c) (i), 12.8)

Example 3 – Financial assets measured at fair value

At 31.03.20X1, an entity purchases listed shares for 100 euros for the purpose of trading, paying an additional 2 euros as transaction fees. At 31.12.20X1, the market value of these shares is 105 euros. Upon selling the shares, 2 euros would have to be paid as brokerage fee. At 31.03.20X2, these shares are sold for 72 euros (in addition, 2 euros is paid as a brokerage fee).

How these shares should be accounted for upon their acquisition, in the balance sheet at 31.12.20X1 and upon their disposal?

The shares are publicly listed, as a result of which they are recognised at fair value, in accordance with clause 11.

The accounting entry upon the acquisition of shares at 31.03.20X1 (in accordance with clause 6, transaction fees are not included in the cost of financial assets measured at fair value):

D Shares	100
C Cash	100
D Financial expense	2

C Cash	2
Revaluation to the market value at 31.12.20X1 (in accordance with clause 14, potential brokerage fees shall not be considered when determining fair value, hence the fair value is 105):	
D Shares	5
C Financial gain on shares	5
Accounting upon the disposal of shares (the loss equals the difference between the carrying amount and the net proceeds received):	
D Cash	70
D Financial loss on shares	35
C Shares	105

16. The best indicator about the fair value of a financial instrument is its market value. In the absence of an active market, fair value can be determined by another method, for example based on the recent purchase-sale transactions of the same or similar financial instruments (adjusting the value for any differences, if necessary) or by using a discounted cash flow method (i.e. by discounting the estimated future cash flows generated by the financial instrument). Upon applying the discounted cash flow method, the discount rate used is the rate of return for similar financial instruments; also, market information should be relied upon as much as possible in determining other inputs. (IFRS for SMEs 11.27-11.29, 12.10)

17. If a reliable measure of fair value is no longer available for a financial assets measured at fair value, the asset's carrying amount at the last date the fair value was reliably measurable shall become its new cost. This asset shall be measured at cost (less impairment) until it once again becomes possible to measure fair value reliably. (IFRS for SMEs 11.32, 12.9).

Financial Assets and Liabilities Measured at Amortised Cost

18. *Upon applying the amortised cost method, a financial instrument is recognised in the balance sheet at its initial cost, which is adjusted, if necessary, by the following amounts (IFRS for SMEs 11.15):*

- (a) repayments of the principal (e.g. in the case of a loan received or granted);*
- (b) cumulative amortisation of a potential difference between the initial amount and the maturity amount (e.g. in the case of bonds);*
- (c) any write-down due to impairment or uncollectibility (in the case of financial assets whose collectibility is estimated as doubtful).*

19. The adjustments of the initial cost described in clause 18 are performed only if they are appropriate. For example, if a financial instrument is repaid in a lump sum, its cost equals the maturity amount or settlement amount and its collection is probable, the amortised cost of the financial instrument equals its initial cost.

20. The amortised cost shall be determined by using the effective interest rate method (which needs not correspond to the nominal interest rate specified in the contract). The effective interest rate is such an interest rate whose application will enable to discount the estimated future cash flows arising from the financial instrument (e.g. from a loan or a bond) to the carrying amount of the instrument. Upon calculating the effective

interest rate, all transaction fees payable or receivable relating to the financial asset or financial liability shall be considered. (IFRS for SMEs 11.16, 11.18).

Example 4 – Calculation of amortised cost by using the effective interest rate

An entity issues a five-year bond with the nominal value of 100,000 euros and an annual interest rate of 8% (payable once a year), for the issue price of 94,418 euros. The costs relating to the issue total 2 000 euros.

(a) How to find the effective interest rate?

The initial cost of the bond equals the cash proceeds received upon bond issuance, less costs relating to the issuance: 94 418 – 2 000 = 92 418 euros.

The effective interest rate is such an interest rate whose application will enable to discount the estimated future cash flows arising from the bond to their initial carrying amount, which in this example is 92 418 euros.

The estimated cash flows arising from the bond over the next five years are as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Interest	8,000	8,000	8,000	8,000	8,000
Principal	-	-	-	-	100,000
Total	8,000	8,000	8,000	8,000	108,000

In order to find the effective interest rate, the following equation needs to be solved (where i is the effective interest rate):

$$\frac{8,000}{1+i} + \frac{8,000}{(1+i)^2} + \frac{8,000}{(1+i)^3} + \frac{8,000}{(1+i)^4} + \frac{108,000}{(1+i)^5} = 92,418$$

This equation is relatively easy to solve with a spreadsheet programme (e.g. Excel).

In this example, the answer is that $i=0.1$ or the effective interest rate is 10%.

As can be seen from the example, the effective interest rate (10%) differs significantly from the bond's nominal interest rate (8%), resulting from the difference between the bond's nominal value (100,000 euros) and its issue price (94,418 euros) and relatively high transaction costs (2,000 euros).

The amount received (or paid) initially for loans does not generally differ from the amount payable at the maturity date, as a result of which the calculation of the effective interest rate is mostly impacted by the costs relating to the transaction. If the costs relating to the transaction are relatively immaterial, the effective interest rate of the loan is similar to its nominal interest rate (as specified in the contract) and the effective interest rate does not need to be calculated.

However, if the transaction costs relating to the loan are material or the amount initially received (or paid) differs from the amount payable, a similar calculation for finding the effective interest rate also needs to be performed for the loans.

(b) How to record the issue of a bond and the subsequent interest calculation?

The bond is recognised initially at its cost in the balance sheet which is the net proceeds received for the bond:

D Cash	92,418
C Bond	92,418

Although the payment of interest is based on the nominal interest rate (8%), the accrued interest shall be calculated based on the effective interest rate (10%). The difference shall be recorded as a change in the bond's carrying amount. At the end of year 1, the following entry will be made:

D	Interest expense	9,242
C	Cash	8,000
C	Bond	1,242

At the end of year 1, the bond is carried on the balance sheet at the amount of $92\,418 + 1\,242 = 93\,660$ euros.

Over the following years, the accrued interest expense is also calculated on the basis of the effective interest rate (10%), which is applied to the bond's carrying amount (in year 2 it is 93,660 euros). The difference is once again recognised as a change in the carrying amount of the bond.

D	Interest expense	9,366
C	Cash	8,000
C	Bond	1,366

Continuing a similar calculation, the bond's carrying amount has increased to 100 000 euros in five years, which also equals its nominal value. Upon maturity, the entry is as follows:

D	Bond	100,000
C	Cash	100,000

21. If the effect of transaction costs to the effective interest rate is immaterial, they can be expensed as incurred based on the materiality principle or expensed on a straight-line basis over the remaining period until the maturity of the instrument. Transaction costs are never capitalised as an separate asset in the balance sheet.

Example 5 – Recognition of transaction fees

An entity borrows 10,000,000 euros for five years, with the annual interest rate of 8%. The costs incurred for concluding the loan contract amount to 20 000 euros.

(a) What is the effective interest rate of the loan and (b) how to recognise the loan under the amortised cost method?

Answer:

The initial cost of this loan is 9 980 000 euros (10 000 000-20 000).

Using the equation shown in the previous example, we find that the effective interest rate of the loan is approximately 8.05% per year. The interest expense calculated on the basis of the effective interest rate differs only slightly from the expense (less than 5,000 euros per year) calculated by using the interest rate specified in the contract (8%). Based on the materiality principle, it is acceptable to expense transaction fees as incurred.

D	Cash	9,980,000
D	Interest expense (transaction fees)	20,000
C	Loan liability	10,000,000

As an alternative, transaction fees can be expensed on a straight-line basis over the period remaining until maturity (i.e. over five years, 4,000 euros annually). In this case, the accounting entries are as follows:

D Cash	9,980,000
C Loan liability	9,980,000

Subsequent annual amortisation calculation of interest and transaction costs:

D Interest expense	800,000
C Cash (paid interest)	800,000
D Interest expense (amortisation of transaction fees)	4,000
C Loan liability	4,000

Both of the above-described simplified accounting policies are allowed only if their application does not lead to a result significantly different from that derived from the application of the effective interest rate.

Impairment of Financial Assets

22. At each reporting date, an entity shall assess whether there is any evidence that a financial asset or a group of financial assets measured at cost or amortised cost is impaired. (IFRS for SMEs 11.21). If any such evidence exists, a financial asset shall be written down pursuant to the following rules (IFRS for SMEs 11.25, 12.13):

(a) financial assets carried at amortised cost (for example, receivables and loans granted) shall be written down to the present value of their estimated future cash inflows (discounted at the financial asset's original effective interest rate);

(b) financial assets measured at cost (shares and other equity instruments whose fair value cannot be determined reliably) shall be written down to the amount that according to a reasoned estimate could be obtained if the financial asset were to be sold at reporting date.

23. Impairment losses shall be recognised as an expense in the income statement. (IFRS for SMEs 11.21).

24. Upon identifying an impairment loss of financial assets (e.g., receivables, loans granted and financial investments), all information that can impact the value of financial assets known at the time of preparing the financial statements shall be taken into consideration (incl. circumstances that have become evident after the reporting date that provide evidence of an impairment that has occurred by the reporting date). Impairment of financial assets (and the resulting write-down) can be caused by any of the following events or circumstances (IFRS for SMEs 11.22, 11.23):

(a) (likely) bankruptcy or significant financial difficulties of the debtor;

(b) delinquency in payments;

(c) lowering of the credit rating of the debtor;

the disappearance of an active market for a certain financial investment due to financial difficulties (e.g. shares delisted on the stock exchange);

(e) an entity has data indicating that the estimated future cash flows from a group of financial assets might have decreased since the initial recognition of those assets, although the decrease cannot be related to any individual financial asset in the group. Such data includes:

- i. adverse changes in the payment status of debtors (for example, an increased number of delayed payments); or
- ii. general deterioration of the economic environment that may impact the debtors' ability to pay (e.g., an increase in the unemployment rate; a decrease in the value of a loan collateral; an increase in the price of raw materials used by debtors or a decrease in the price of finished goods).

25. An entity shall assess the impairment of financial assets separately for each asset for the following financial assets:

- (a) investments in shares or other equity instruments; and
- (b) other financial assets that are individually significant.

Other financial assets that are not individually significant and for which there is no direct evidence of their impairment can be assessed collectively for impairment. (IFRS for SMEs 11.24) Financial assets whose impairment has been individually assessed shall not be included in a group of financial assets assessed collectively if they exhibited individual signs of impairment; they shall be included in the group of financial assets assessed collectively if they lack individual signs of impairment.

Example 6 – Assessment of receivable in case of known impairment

Upon the assessment of collectibility of receivables at the end of the year, an entity's management identifies that in three cases the due date of receivables was exceeded significantly and the debtors are either insolvent or in financial difficulties. Each receivable is written down individually, based on the present value of the expected collectible amounts.

Example 7 – Assessment of receivable in case impairment is not directly known

Trade receivables are carried in the books of an entity at the year-end in the total amount of 500,000 euros, comprising of more than 300 separate receivables. There is no good reason to believe that any of the individual receivables may be uncollectible (i.e. impairment has not been directly identified for any of the receivables). However, prior experience has shown that 3% of even the so-called "good receivables" are not collected on average. The entity sets up an allowance for the write-down of a portfolio of receivables in the amount of 15,000 euros (3% of 500,000).

Accounting entry:

D	Impairment loss on receivables	15,000
C	Allowance for doubtful receivables	15,000

26. In case the recoverable amount of financial assets previously written down increases in subsequent periods and the increase in value can objectively be attributed to an event that occurred after recording the write-down, the previously recognised impairment shall be reversed up to the amount that is lower of the following two amounts:

- (a) the present value of expected future payments arising on financial assets; and
- (b) the carrying amount if the impairment had not previously occurred.

The reversals of impairment losses shall be recognised in the income statement. (IFRS for SMEs 11.26).

SUBSEQUENT MEASUREMENT – SPECIFIC AREAS

Measurement of Receivables

27. All receivables (e.g. trade receivables, accrued income, loans granted and other short and long-term receivables) shall generally be carried at amortised cost in the balance sheet.

28. The amortised cost of short-term receivables generally equals their nominal value (less any impairment allowances), therefore short-term receivables are recorded in the balance sheet in their expected realisable value (which is, for example, reported in an invoice, contract or other source document).

29. For determining the amortised cost of long-term receivables they are initially recognised at the fair value of the consideration receivable (see also the example 1), and subsequently interest income is recognised on the receivable using the effective interest rate method. If the effective interest rate of a long-term receivable differs from the nominal interest rate specified in the contract (e.g., in the case of an interest-free loan), the receivable shall initially be recognised at its present value by discounting it using the prevailing market rate of interest for a similar instrument (e.g. similar as to currency, term, credit rating, etc.).

Example 8 – Recognition of interest-free loans

An entity grants an interest-free three-year loan to its subsidiary in the amount of 1,000,000 euros. How to record the loan granted in the books of the parent entity and the subsidiary (assuming the discount rate of 10%)?

Answer:

The fair value of the loan at the time of its issue is 751,315 euros (i.e. the present value of 1 million euros by discounting the consideration receivable in three years by 10%-ga or $1,000,000 / 1.1^3$). The difference between the nominal value and the present value is recognised in interest income over three years.

An accounting entry upon the issuance of the loan in the books of the parent entity:

D Long-term receivable	751,315
D Financial expenses	248,685
C Cash	1,000,000

Calculation of interest using the effective interest rate at the end of year 1:

D Long-term receivable	75,131
C Interest income	75,131

Continuing similar interest calculation, the balance of the receivable will increase to 1,000,000 euros by the end of year 3, equalling the nominal value of the payable amount of receivable.

The subsidiary records the loan received as the so-called mirror image. An accounting entry at the time of the receipt of the loan in the books of the subsidiary:

D Cash	1,000,000
C Long-term liability	751,315
C Financial income	248,685

Calculation of interest using the effective interest rate at the end of year 1:

D Interest expense	75,131
C Long-term liability	75,131

Continuing similar interest calculation, the balance of the liability will increase to 1,000,000 euros by the end of year 3, equalling the nominal value of the liability payable.

Example 9 – Recognition of loans granted under market conditions

Entity A grants a three-year loan to an entity B in the amount of 1 000 000 euros with the annual interest rate of 8%. The transaction occurs at market conditions and the interest on the loan equals the market interest rate with similar terms and of entities with similar credit ratings.

As the nominal interest rate of the loan equals the market interest rate and there are no transaction costs that could impact the calculation of the effective interest rate, the nominal interest rate of the loan equals its effective interest rate. The fair value of this loan at the time of its issue corresponds to the cash amount paid or 1,000,000 euros.

An accounting entry upon the issuance of the loan:

D Long-term receivable	1,000,000
C Cash	1,000,000

The calculation of interest at the end of year 1 (the effective interest rate equals the interest rate specified in the contract, as a result of which interest income equals the amount of interest receivable):

D Cash	80,000
C Interest income (8% of the receivable)	80,000

30. Impairment losses of receivables shall be recognised in the appropriate contra asset account (for example, impairment losses of “Trade receivables” shall be included in the balance sheet contra asset account “Allowance for doubtful receivables”) or as a reduction of the carrying amount of the receivable.

31. If the impairment loss of a receivable was initially recognised in the contra asset account designed for it but later it becomes evident that the collection of the receivable is completely unrealistic, the receivable shall be deemed irrecoverable and both the receivable itself as well as its impairment in the corresponding contra asset account shall be written off (no additional loss is incurred). A receivable is deemed irrecoverable when an entity lacks all opportunities to collect the receivable (e.g. the debtor has been declared bankrupt and the bankruptcy estate is not adequate to pay the receivable).

32. If a previously made estimate on the amount of doubtful receivables changes subsequently, it shall be recognised in the income statement in the period when the

change occurred and it shall not be adjusted retrospectively. The collection of doubtful or irrecoverable receivables shall be shown as a reduction of an expense in the period when the collection occurs. Upon the collection of a doubtful receivable both the balances of the receivable itself as well as its contra asset account shall be reduced.

Measurement of Financial Investments

33. Short and long-term financial investments in shares and other equity instruments (except for such ownership interest in subsidiaries and associates that are accounted for using the consolidation or equity method) shall be recognised at fair value if it can be measured reliably (see example 3). The fair value of shares and other equity instruments cannot be determined reliably if they are not traded actively and there are no alternative methods for reliable determination of their value – such shares are carried at cost (less an allowance for impairment if the recoverable amount of the investment has fallen below its carrying amount).

34. Short and long-term financial investments in bonds and other debt instruments may be measured at amortised cost or fair value if an entity plans to hold them until maturity (see example 4). If the entity is not certain at the time of acquisition whether it will hold a certain debt instrument until its maturity or it is probable that it will sell it before maturity, it shall be measured at fair value in accordance with clause 11.

35. The fair value of bonds and other debt instruments can generally be determined reliably as the amount and timing of cash flows derived from them (e.g. interest and principal payments) are known or can be measured reliably.

Measurement of Financial Liabilities

36. Financial liabilities (e.g. borrowings, trade payables, accrued expenses, bonds issued and other short and long-term borrowings, except for derivatives) are generally carried at amortised cost in the balance sheet.

37. The amortised cost of short-term financial liabilities generally equals their nominal value; therefore short-term financial liabilities are carried in the balance sheet in their redemption amount (for example, reported in an invoice, a contract or some other source document).

38. For calculating the amortised cost of long-term financial liabilities they are initially recognised at the fair value of the consideration payable (see also examples 1, 4 and 5), by calculating interest expense on the liabilities in the following periods using the effective interest rate method.

Measurement of Derivatives

39. Derivatives (e.g. forward, future, swap or option contracts) are carried in the balance sheet at their fair value.

<u>Example 10 – Recognition of Derivatives</u>
--

At 1.07.20X1, an entity enters into a 12-month currency forward contract that obligates it to purchase 1 million USD at the rate of USD 1 = EUR 0.85 at 30.06.20X2. At 31.12.20X1 the exchange rates of USD/EUR are as follows:

Spot rate USD 1 = EUR 0.75
 6-month forward rate USD 1 = EUR 0.8
 12-month forward rate USD 1 = EUR 0.85

How and at which amount shall the entity account for the forward contract in its financial statements as at 31.12.20X1?

The forward contract entered into by the entity obligates it to purchase 1 million US dollars for 850,000 euros at 30.06.20X2. At the reporting date (31.12.20X1), the entity can enter into a forward contract with the same maturity date enabling it to purchase 1 million US dollars for 800,000 euros (or 50,000 more favourably than the current contract). As at 31.12.20X1, the fair value of the given forward contract is 50,000 euros.

An entry in the books:

D Loss on derivatives	50,000
C Derivatives	50,000

The derivative with a negative fair value is reported under liabilities in the balance sheet.

40. If a certain derivative has been acquired for hedging purposes, it is acceptable to apply special rules for hedge accounting described in sections 12.15-12.25 of IFRS for SMEs for its measurement (hedge accounting), assuming that the instrument meets the requirements set out in sections 12.15-12.18 of IFRS for SMEs.

DERECOGNITION

Derecognition of Financial Assets

41. *A financial asset shall be derecognised when an entity (IFRS for SMEs 11.33):*
 (a) *loses its right to the cash flows arising from the financial asset; or*
 (b) *it transfers to a third party the cash flows derived from the financial asset and substantially all risks and rewards of ownership of the financial asset.*

42. If one party transfers a financial asset to another party without transferring the risks and rewards of ownership relating to the financial asset, the asset shall not be derecognised in the balance sheet of the transferor but the transaction shall be recognised as a loan whose collateral is the transferred asset. (IFRS for SMEs 11.34) Examples of such transactions are:

- (a) the factoring of receivables where substantially all the risks of ownership are retained by the “seller”;
- (b) repurchase transactions with securities in which case the “seller” of securities undertakes to repurchase the “sold” securities at an agreed time and under agreed terms.

43. Upon derecognition of a financial asset, the difference between the carrying amount of a financial asset and the consideration received for it shall be recognised in profit or loss. (IFRS for SMEs 11.33).

Factoring of Receivables

44. A factoring contract is the sale of receivables whereby depending on the type of the factoring contract the buyer has the right to sell back the transferred receivable to the seller within a certain time period (factoring with recourse) or there is no sell back right and all the risks and rewards of ownership of a receivable are transferred from the seller to the buyer (factoring without recourse).

45. If the “seller” retains the repurchase obligation, the transaction shall be recognised as a financing transaction (i.e. as a loan whose collateral is the receivable) and not a sale. A receivable is not considered as sold as a result of the factoring but it remains in the balance sheet until the receivable is collected or the recourse right has expired. If there is no repurchase obligation and the receivable together with the risks and revenue relating to it are actually transferred to the buyer, the transaction shall be recognised as a sale of the receivable.

Example 11 – Recognition of Factoring

An entity sells receivables with the nominal value of 100,000 euros and maturity dates of up to three months to a leasing company, receiving 90,000 euros for it. The receivables had previously been carried in the balance sheet at their nominal value.

Version A - All the risk for the collection of receivables is transferred to the leasing company (factoring without recourse)?

A factoring contract entered into under such terms shall be recognised as a sale of receivables:

D	Cash	90,000
D	Expense	10,000
K	Receivables	100,000

The expense is either recognised as a financing expense (similarly to an interest expense) or as the expense of an impairment of receivables depending on whether the transaction was concluded for the purpose of cash flow management or hedging the risk of bad receivables.

Version B – All risks and gains of servicing the receivables remain with “the seller”. Three months after concluding the transaction, the leasing company has the right to sell the uncollected receivables back to the entity, receiving interest income at the agreed upon amount in addition to the nominal value. If the receivable is collected during that period, interest is deducted from it and the portion exceeding it shall be returned to the entity.

As “the buyer” has the right to sell back the receivables, the transaction shall be recognised as a financing transaction (as a loan with the receivables as collateral), and

not a sales transaction.

D Cash	90,000
C Factoring liability	90,000

The entity shall calculate accrued interest expense on the loan received. Upon the collection of the receivable, offsetting with the factoring liability and refunding the remaining portion to the entity, the following entry shall be made (assuming that the interest expense totalled 1 000 euros):

D Interest expenses	1,000
D Factoring liability	90,000
D Cash	9,000
C Receivables	100,000

Derecognition of Financial Liabilities

46. *A financial liability shall be derecognised when it is discharged, cancelled or expires. (IFRS for SMEs 11.36).*

47. A financial liability is discharged when it is paid off or contractually transferred to another party. A financial liability is cancelled when the other party has cancelled it. A financial liability expires at the dates provided for in legislation.

48. Upon derecognition of a financial liability, the difference between the carrying amount of the liability and the consideration paid for it shall be recognised as income or expense in the income statement. (IFRS for SMEs 11.38).

ACCOUNTING FOR EQUITY INSTRUMENTS

49. The classification of financial instruments into financial liabilities or equity instruments is based on their economic substance and not only on their legal form. For example, if certain preference shares meet the definition of a liability rather than that of equity, it shall be recognised as a liability in the balance sheet despite the fact that the word “share” is used to denote the instrument.

50. If the issuer of a financial instrument has a contractual obligation to pay an agreed amount of cash or other financial assets to the holder of the instrument, the instrument shall be recognised as a financial liability. If the issuer of a financial instrument has no obligation to make payments at the agreed amounts relating to the instrument (instead, the holder of the instrument participates in the profit or net assets of the entity), the financial instrument is an equity instrument.

51. If the entity issues a financial instrument with both a financial liability and an equity component (e.g. convertible bond), the entity shall allocate the consideration received between these components as follows: at first it shall calculate the value of the financial liability component which is the fair value of a similar financial liability without conversion rights. The remainder of proceeds shall be allocated to the equity component. Transaction costs shall be allocated between the components on the basis of their relative fair values. (IFRS for SMEs 22.13).

52. Interest, dividends and other gains and losses relating to instruments recognised as financial liabilities in the balance sheet shall be recognised as income or expense in the income statement (e.g. interest expense on loans and bonds, dividends on preference shares reported as a liability in the balance sheet; gain (loss) on loan refinancing).

53. Expenditures and proceeds relating to instruments recognised as equity in the balance sheet shall be recognised as changes in equity in the balance sheet (e.g. dividend payments on ordinary shares; “gain/loss” on the sale of treasury shares). (IFRS for SMEs 22.17).

Example 12 – Preference shares with fixed dividends

An entity has issued preference shares guaranteeing annual fixed dividends of at least 10% to their holders. In case the entity is not sufficiently profitable in a certain financial year, the unpaid dividends will accumulate (earning interest) and they shall be distributed at the first opportunity.

Such preference shares shall be recognised as a liability in the balance sheet of the issuer as the entity issuing the preference shares has the obligation to make periodic fixed payments. Dividends paid on such preference shares shall be recognised as a financial expense in the income statement (similarly to loan interest), and not as a reduction of retained earnings.

Example 13 – Preference shares with unfixed dividends

An entity has issued preference shares which guarantee their holders a dividend that is 10% higher than that distributed to ordinary shareholders. The distribution or non-distribution of dividends and their amount are determined each time at the general meeting of shareholders.

Such preference shares shall be recognised as equity instruments as the entity that has issued them has no obligation to make periodic fixed payments to their holders. Dividends paid on such preference shares shall be recognised as a reduction of retained earnings (similarly to dividends on ordinary shares).

54. If dividends are paid through the distribution of other assets than cash, the dividend liability shall be recorded at the fair value of assets to be distributed. At each reporting date and asset distribution date the fair value of assets shall be measured and in case it has changed the carrying value of the dividend liability shall be adjusted. The effect of fair value change shall be recorded as an adjustment to the item "Retained earnings". (IFRS for SMEs 22.18) Upon asset distribution, the difference between the carrying values of assets distributed and the dividend liability shall be recorded in the income statement.

55. Equity instruments shall be recognised after an entity has issued these instruments and the other party has a contractual obligation to pay for them (IFRS for SMEs 22.7):

- (a) if equity instruments are issued before the entity receives the consideration from them (e.g. in founding a private limited company without making contributions), it shall be recorded as follows:
 - i. if the entity has no unconditional claim right against the owner (e.g. if the owner is only obligated to pay for their shares or units in certain situations), the

receivable from the owner and the respective equity capital increase shall not be recorded on the balance sheet. An increase in equity capital shall be recorded only after a contribution has been made or after an unconditional claim of the entity has arisen against the owner (see example 14).

ii. if the entity has an unconditional claim against the owner (e.g., if the owner is obligated to make a contribution by a certain date), the entity may record on its balance sheet a receivable against the owner at the fair value of the consideration receivable (see example 15) or address this situation as a forward contract on shares by recording shares issued under the forward contract after they are paid for (see example 16);

(b) if the entity receives its proceeds before having issued equity instruments and if the entity is not under the obligation to repay the proceeds, the consideration received shall be recorded as an equity increase.

Example 14 – The entity has no unconditional claim right against the shareholder

Based on the memorandum of association, the private limited company has a share capital of 25 000 euros, of which only 5 000 euros shall be contributed upon formation. The remaining share capital is only payable if the private limited company lacks the assets to discharge its obligations.

As the private limited company has no unconditional right to claim for payment of the unpaid share capital (it can only be claimed under certain conditions), the private limited company cannot record a receivable from the owner on its balance sheet.

Thus, at the date of foundation, the private limited company's balance sheet is as follows (the portion of nominal equity and unmade contribution should be separately presented either on the balance sheet or in the notes to the financial statements):

Assets	
Cash	5,000
Total assets	5,000
Liabilities and equity	
Share capital at nominal value	25,000
Other equity	-20,000
Total equity	5,000

Example 15 – The entity has an unconditional claim right against the shareholder

Version A

(accounting for issued shares for which consideration has not been received)

Based on the memorandum of association, the private limited company has a share capital of 25 000 euros, of which only 5 000 euros shall be contributed upon formation. The remaining share capital is payable within two years from the foundation of the private limited company.

As the private limited company has a contractual right to claim for payment of the unpaid share capital from the owner, it shall record a receivable from the owner on its balance sheet by discounting it to present value. The difference between the present value and nominal value of shares shall be recorded as a reduction of equity. Interest income shall be recorded in the income statement on the receivable from the shareholder until the receivable has been collected.

Assuming that the present value of 20 000 euros receivable in two years, latest, is 18 000 euros, the balance sheet at the date of formation is as follows (the portion of nominal equity and unmade contribution should be separately presented either on the balance sheet or in the notes to the financial statements):

Assets	
Cash	5,000
Receivable from shareholder	18,000
Total assets	23,000
Liabilities and equity	
Share capital at nominal value	25,000
Other equity	-2,000
Total equity	23,000

Version B

Alternatively, it could be claimed that in essence it is a forward contract on shares issued by the private limited company that shall be recorded only after they are paid for.

At the date of foundation, the private limited company's balance sheet is as follows (the portion of nominal equity and unmade contribution should be separately presented either on the balance sheet or in the notes to the financial statements):

Assets	
Cash	5,000
Total assets	5,000
Liabilities and equity	
Share capital at nominal value	5,000
Total equity	5,000

56. Equity instruments shall be recorded at the fair value of proceeds received or receivable less issuance costs. (IFRS for SMEs 22.8) If the fair value of proceeds receivable differs from the nominal value of issued equity instruments, the positive difference shall be recorded in the item "Share premium" and the negative difference as a reduction of "Share premium" in case it has a positive balance, otherwise in the item "Retained earnings".

57. Equity instruments repurchased by an entity (e.g. treasury shares) shall be recognised as a reduction of equity in the balance sheet (in the item "Treasury shares"), not as a financial investment. (IFRS for SMEs 22.16).

58. Costs incurred for the issuance or repurchasing of equity instruments (e.g. shares) shall be recognised as a reduction of equity (in the item "Share premium", if it has a positive balance, otherwise in the item "Retained earnings"), and not as an expense in the income statement. Exceptions are costs relating to incomplete transactions (e.g. a failed share issue), that shall be recognised as an expense in the income statement. (IFRS for SMEs 22.9, 22.16).

59. Pursuant to the above-described criteria, certain entities may not have equity at all. Examples are:

(a) a branch office of a foreign company that reports its net balance to the head office as a financial liability or a financial receivable;

(b) entities that are required (either pursuant to legislation or the articles of association of the entity itself) to unconditionally repurchase the shares or units from its owners at an agreed price – the shares or units issued shall be accounted for as financial liabilities. As an exception, contributions made by members to associations established under the Commercial Associations Act that meet the following conditions are recognized in equity:

- i. they participate proportionately in the distribution of profits or the covering of losses of the association; and
- ii. are subordinate to all other debt instruments and, in the event of the liquidation of the association, are paid last after the claims of other creditors.

COMPARISON WITH IFRS FOR SMES

60. The requirements prescribed in ASBG 3 for financial instruments are generally in accordance with the accounting policies prescribed in sections 11 and 12 of IFRS for SMEs, except:

(a) In accounting for financial instruments, IFRS for SMEs allows to choose whether to apply sections 11 and 12 of IFRS for SMEs or IAS 39. The Accounting Standards Board did not deem it necessary to establish such a choice;

(b) based on the materiality principle, clause 21 of ASBG 3 allows the application of a simplified amortised cost method (instead of applying the effective interest rate, a straight-line interest calculation or the expensing of transaction fees as incurred), if the effect on the statements is insignificant. Section 11 of IFRS for SMEs does not mention directly this simplified approach, but according to section 10.3 the accounting methods described need not be applied if the effect of their application is immaterial;

(c) section 12 of IFRS for SMEs describes special rules for accounting for derivative financial instruments that have been acquired for the purpose of risk management (hedge accounting). The Board did not deem it necessary to describe these special rules in ASBG 3 as the number of companies applying such rules in Estonia is relatively small. ASBG 3 allows the application of special rules of hedge accounting described in section 12 of IFRS for SMEs;

(d) depending on whether management is or is not planning to hold to maturity publicly listed bonds, ASBG 3 respectively either permits or requires that the bonds be recorded at fair value. Pursuant to section 11 of IFRS for SMEs, investments in such bonds are measured, as a rule, at amortised cost. The Board finds that it is easier to measure publicly listed bonds at fair value;

(e) there are differences in a few other details.

61. The policies prescribed in ASBG 3 for the classification of financial instruments into liabilities and equity are in compliance with the policies of section 22 of IFRS for SMEs. An exception is the recognition in equity of contributions made by members to associations established under the Commercial Associations Act. IFRS for SMEs Chapter 22 significantly restricts the recognition of such contributions in equity. The Board deemed that recognition of contributions in equity (provided that the criteria specified in clause 59(b) are met) better corresponds to established practice in the Estonian economic environment, legislative analogy with other associations and the expectations of users of financial statements.