

Introducing the series

Our series of *IFRS for Investment Funds* publications addresses practical application issues that investment funds may encounter when applying IFRS. It discusses the key requirements and includes interpretative guidance and illustrative examples. The upcoming issues will cover such topics as fair value, IFRS 9 *Financial Instruments*, consolidation and disclosure of operating segments.

This series considers accounting issues from currently effective IFRS as well as forthcoming requirements. Further discussion and analysis about IFRS is included in our publication *Insights into IFRS*.

What's in this issue?

This issue covers the presentation and measurement of financial assets carried at fair value subsequent to initial recognition and classified as:

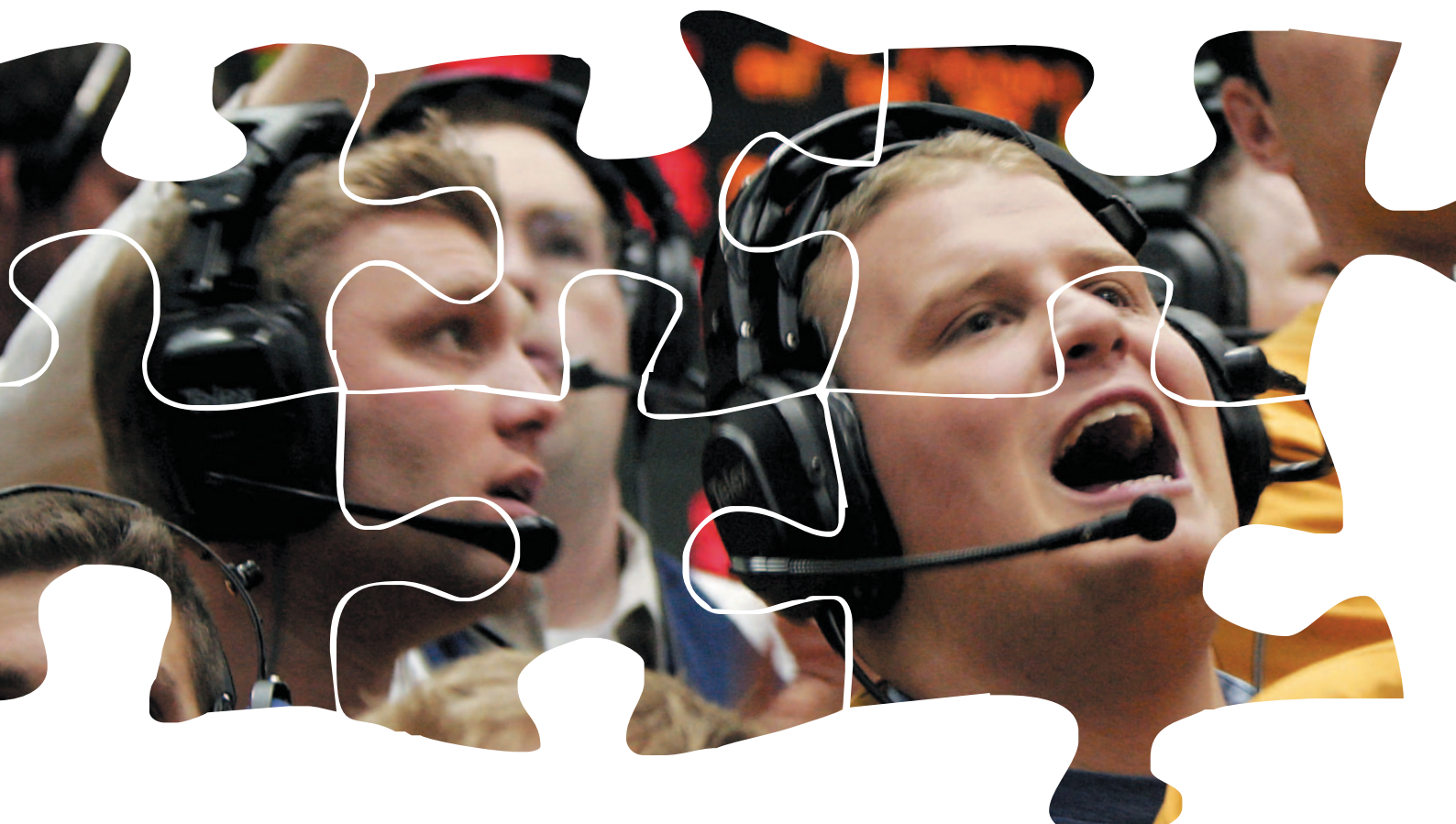
- at fair value through profit or loss, which are financial assets held for trading or designated as at fair value through profit or loss; and
- available for sale.

These are the financial asset classifications most frequently used by investment funds. This issue illustrates the related calculations and explores disclosure options applied by investment funds, by considering the following questions.

1. How do you calculate effective interest rate (EIR) and amortised cost?
2. How do you apply the EIR method to calculate interest income from a floating rate instrument?
3. How do you present gains and losses on financial assets at fair value through profit or loss in the statement of comprehensive income?
4. How do you determine and present gains and losses on available-for-sale debt investments?
5. How do you determine and present gains and losses on available-for-sale equity instruments?
6. Can realised gains and losses on financial assets at fair value through profit or loss be disclosed separately from unrealised ones?

The impact of IFRS 9 on financial assets will be discussed in a future issue.

This issue covers only financial assets that are not a part of a qualifying hedging relationship.



1. How do you calculate EIR and amortised cost?

An EIR needs to be calculated to determine interest income for all debt investment measured at amortised cost or classified as available for sale. In addition, investment funds that voluntarily present interest income or expense from debt investments at fair value through profit or loss separately from other gains and losses also use the EIR method to calculate interest (see Question 3 for more detail).

EIR is calculated for a financial instrument (or a group of financial instruments) as follows

The EIR exactly discounts the estimated stream of future cash payments and receipts over the expected life to the net carrying amount on initial recognition.

The calculation takes into account all contractual cash flows, but excludes any future credit losses.

When purchasing distressed debt investments whose purchase price reflects credit losses that have already occurred, future cash flows are estimated inclusive of such credit losses.

Only in rare cases when it is not possible to determine estimated cash flows or the expected life of a financial instrument or a group of similar financial instruments, are contractual cash flows over the full contractual term used.

Example 1 – Calculating EIR

On 30 June 2011 Fund X purchased debt investments for 450,000 including broker fees. The notional is 500,000. A fixed semi-annual coupon of 8,000 is receivable on 30 June and 31 December. The securities mature on 30 June 2013.

The EIR for six months is 4.3796%, calculated by solving 'x' in the following equation.

$$450,000 = \frac{8,000}{(1+x)} + \frac{8,000}{(1+x)^2} + \frac{8,000}{(1+x)^3} + \frac{(500,000 + 8,000)}{(1+x)^4}$$

The EIR is calculated for six months because the fund recognises interest and updates amortised cost every six months.

Assuming that the instrument is not impaired, the amortised cost for each period is calculated as follows.

Reporting date	Interest income	Coupon received during the period	Amortised cost
30 June 2011			450,000
31 December 2011	19,708	8,000	461,708
30 June 2012	20,221	8,000	473,929
31 December 2012	20,756	8,000	486,685
30 June 2013	21,315	8,000	500,000
Total	82,000	32,000	

- The effective interest of 19,708 for the first six months is calculated as:

$$\begin{array}{ccc} \text{Amortised cost at the beginning of the period of 450,000} & \times & \text{EIR of 4.3796\%} \end{array}$$

- The amortised cost at the end of the period is calculated as:

$$\begin{array}{ccccc} \text{Amortised cost at the beginning of the period} & + & \text{Interest for the period} & - & \text{Coupon received during the period} \end{array}$$

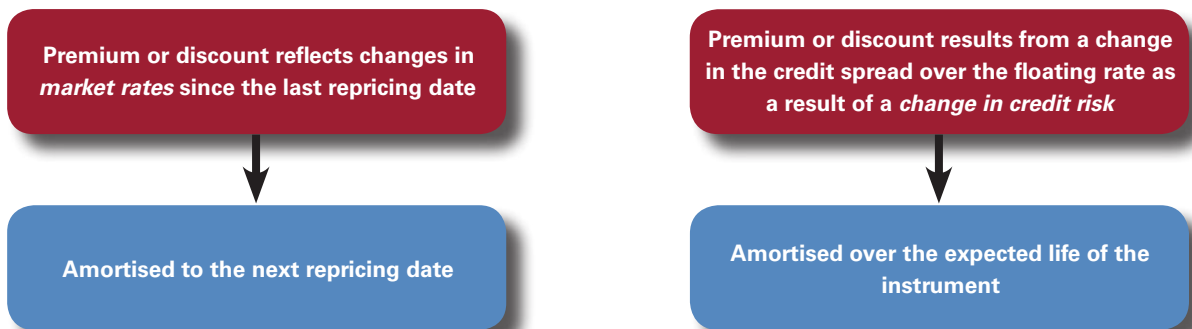
2. How do you apply the EIR method to calculate interest income from a floating rate instrument?

The EIR of a floating rate instrument changes as a result of periodic re-estimation of determinable cash flows to reflect movements in market interest rates. However, if the instrument is recognised at an amount equal to the principal receivable or payable on maturity, then this periodic re-estimation does not have a significant effect on its carrying amount. Therefore, for practical reasons, in such cases the carrying amount is usually not adjusted at each repricing date, because the impact is generally insignificant.

For floating rate assets, the following method is used to calculate interest income for the period.



The treatment of an acquisition discount or premium on a floating rate instrument depends on the reason for that discount or premium. For example:



IAS 39 *Financial Instruments: Recognition and Measurement* does not prescribe any specific methodology for how transaction costs should be amortised for a floating rate instrument, except as discussed in IAS 39.AG6. In our view, any consistent methodology that would establish a reasonable basis for amortisation of the transaction costs may be used. For example, it would be reasonable to determine an amortisation schedule of the transaction costs based on the interest rate in effect at inception.

In our view, this approach also could be applied for a floating rate instrument with embedded derivatives that are not separated, e.g. an instrument on which the interest rate is subject to market indices such as inflation.

3. How do you present gains and losses on financial assets at fair value through profit or loss in the statement of comprehensive income?

The entire fair value change on debt and equity instruments at fair value through profit or loss may be presented on a net basis as a single line item in the statement of comprehensive income. As an alternative, an investment fund can present foreign exchange gains and losses and interest income separately from other fair value changes. The selected presentation method, once it is adopted, is applied consistently and disclosed in the financial statements.

If interest income is presented separately, then it is measured on an effective interest basis. See Question 1 for further information on calculating amortised cost and determining the EIR.

4. How do you determine and present gains and losses on available-for-sale debt investments?

The table below summarises the requirements on determination and presentation of income and expense on available-for-sale debt investments. It also shows when foreign exchange gains and losses and interest income from debt investments at fair value through profit or loss are presented as separate line items, segregated from other fair value changes.

	Where presented	What is recognised in the reporting period?
Interest income	Profit or loss	<p>Interest calculated using the EIR method in the currency of denomination of the instrument.</p> <p>Interest income is recorded in the functional currency at the rate of exchange at the date of the transaction, or at rates that approximate the actual exchange rates, e.g. an average exchange rate for a specific period when exchange rates do not fluctuate significantly.</p> <p>Once a financial asset has been written down as a result of an impairment loss, interest income for assets at amortised cost is recognised thereafter using the rate of interest used to discount the future cash flows for the purpose of measuring impairment loss. For fixed rate assets measured at amortised cost, this rate is generally the original EIR. In our view, for an available-for-sale financial asset, a fund may use a new EIR computed based on the fair value at the date of impairment.</p>
Foreign exchange gains and losses	Profit or loss	<p>Calculated as the difference between:</p> <ul style="list-style-type: none"> • amortised cost in the foreign currency at the end of the period translated into the functional currency at the spot exchange rate at that date; and • amortised cost in the functional currency at the beginning of the period adjusted for the functional currency amounts of interest income and any receipts during the period. <p>Interest income and any receipts are recorded in the functional currency at the rate of exchange at the date of the transaction, or at rates that approximate the actual exchange rates, e.g. an average exchange rate for a specific period when exchange rates do not fluctuate significantly.</p>
Impairment losses	Profit or loss	<p>Calculated as the difference between acquisition cost (net of any principal impairment and amortisation) and current fair value, less any impairment loss previously recognised in profit or loss.</p> <p>There is no specific guidance on how to measure impairment losses for monetary financial assets denominated in a foreign currency. In our view, the fair value is first determined in the foreign currency and is then translated into the functional currency using the exchange rate of the date on which the impairment is recognised.</p>
Reversal of impairment	Profit or loss	<p>In our view, determining the amount of the impairment loss that is reversed through profit or loss depends on the fund's accounting policy.</p> <p>In our view, the reversal should be recognised at the spot exchange rate of the date on which the reversal is recognised.</p> <p>See 7.6.610 in the 8th Edition 2011/12 of our publication <i>Insights into IFRS</i> for more detail.</p>

	Where presented	What is recognised in the reporting period?
Other gains and losses on remeasurement to fair value	Other comprehensive income	<p>The cumulative gain or loss is recognised in other comprehensive income, and is the difference at the end of the period between:</p> <ul style="list-style-type: none"> • fair value in the functional currency (being the fair value in the foreign currency translated at the spot rate); and • amortised cost in the functional currency (being the amortised cost in the foreign currency translated at the spot rate).

Example 2 – Accounting for available-for-sale debt investments with a fixed coupon

On 30 June 2011 Fund X purchased debt investments for 450,000 including broker fees. A fixed semi-annual coupon of 8,000 is receivable on 30 June and 31 December. The securities mature on 30 June 2013. The notional is 500,000. The fair value of the securities on 31 December 2011 is 470,000. The six-monthly EIR calculated in foreign currency is 4.3796%.

The exchange rate from the foreign currency to X's functional currency was 1 to 1.5 on 30 June 2011, and is 1 to 1.7 on 31 December 2011.

X concludes that an average rate for the period approximates the exchange rates on the dates of transactions. The average foreign currency to functional currency exchange rate for the period is 1 to 1.6.

1. Accounting entries on 30 June 2011 (in foreign currency)

	Purchase of debt investments	Debit	Credit
Asset	Available-for-sale financial assets	450,000	
Asset	Cash		450,000

2. Accounting entries on 31 December 2011 (in foreign currency)

	Coupon received	Debit	Credit
Asset	Cash	8,000	
Asset	Available-for-sale financial assets		8,000
	Interest income	Debit	Credit
Asset	Available-for-sale financial assets	19,708	
Profit or loss	Interest income		19,708

The interest income amount is sourced from Example 1.

3. Accounting entries on 31 December 2011 (in functional currency)

a. Foreign exchange gains and losses

The foreign exchange gain on 31 December 2011 is calculated as follows.

	In foreign currency	In functional currency
Amortised cost on 30 June 2011 converted at spot rate of 1.5	450,000	675,000
Interest income for 6 months to 31 December 2011 converted at average rate of 1.6	19,708	31,533
Coupon received on 31 December 2011 converted at spot rate of 1.7	(8,000)	(13,600)
Amortised cost on 31 December 2011 (the total)	461,708	692,933
Amortised cost in foreign currency converted at spot rate of 1.7		(784,904)
Foreign exchange gain		(91,971)

The accounting entries for the foreign exchange gain are as follows.

Foreign exchange gains and losses		In functional currency	
		Debit	Credit
Asset	Available-for-sale financial assets	91,971	
Profit or loss	Foreign exchange gain		91,971

b. Other gains and losses on remeasurement to fair value

The cumulative gains and losses recognised in other comprehensive income are calculated as the difference between amortised cost and fair value on 31 December 2011 in X's functional currency converted from foreign currency at spot rate.

	Amortised cost	Fair value	Difference between amortised cost and fair value/ other gains or losses
Available-for-sale financial assets in foreign currency	461,708	470,000	
Available-for-sale financial assets in functional currency converted at spot rate of 1.7	784,904	799,000	14,096

- The amortised cost in the foreign currency of 461,708 is sourced from Example 1.
- The amortised cost in the functional currency of 784,904 is calculated by applying the period end spot exchange rate of 1.7 to the amortised cost in the foreign currency of 461,708.
- The fair value in the functional currency of 799,000 is calculated by applying the period end spot exchange rate of 1.7 to the fair value in the foreign currency of 470,000.

Other gains and losses in the functional currency include the change in fair value in the foreign currency as well as the foreign exchange gain or loss on re-translation of the opening balance in other comprehensive income.

The accounting entries for other gains and losses on remeasurement to fair value are as follows.

	Other gains and losses on remeasurement to fair value	In functional currency	
		Debit	Credit
Asset	Available-for-sale financial assets	14,096	
Other comprehensive income	Other gains and losses on remeasurement to fair value		14,096

c. Movement in the available-for-sale financial assets account in 2011

The entries in the functional currency can be summarised as follows.

	In functional currency	
	Debit	Credit
Purchase price, including transaction costs	675,000	
Interest income for 2011	31,533	
Coupon received on 31 December 2011		13,600
Other gains and losses on remeasurement to fair value	14,096	
Foreign exchange gain	91,971	
Total	812,600	13,600
Balance at 31 December 2011	799,000	

5. How do you determine and present gains and losses on available-for-sale equity instruments?

The table below summarises the determination and presentation requirements for gains and losses on available-for-sale equity investments.

	Where presented	What is recognised in the reporting period?
Dividend income	Profit or loss	Generally, equals the amount declared. See 7.6.760 in the 8th Edition 2011/12 of our publication <i>Insights into IFRS</i> for more detail on recognition of dividend income.
Impairment losses	Profit or loss	The difference between the acquisition cost and the current fair value measured in the functional currency, less any impairment loss previously recognised in profit or loss.
Other gains and losses (including reversal of impairment)	Other comprehensive income	Cumulative gains and losses recognised in other comprehensive income is the difference between the fair value at the beginning and the end of the reporting period measured in the functional currency. Foreign exchange gains and losses are not separated from the total fair value changes.

Example 3 – Accounting entries for the available-for-sale equity investment

On 30 September 2009 Fund X purchased shares in Company C for 3,000.

		Debit	Credit
Asset	Available-for-sale financial assets	3,000	
Asset	Cash		3,000

X declared a dividend of 200 on 31 December 2009.

		Debit	Credit
Asset	Dividend receivable	200	
Profit or loss	Dividend income		200

On 31 December 2009 the fair value of the shares was 3,500, representing an increase of 500 from 30 September 2009. The fair value of 3,500 is determined based on the quoted ex-dividend price.

		Debit	Credit
Asset	Available-for-sale financial assets	500	
Other comprehensive income	Other gains and losses on remeasurement to fair value		500

A dividend of 200 was paid on 15 January 2010.

		Debit	Credit
Asset	Cash	200	
Asset	Dividend receivable		200

On 31 December 2010 the fair value of the shares decreased by 1,500 to 2,000. X determined that this investment was impaired at that date.

The accounting entries as at 31 December 2010 are set out below. The shares are first revalued to fair value in other comprehensive income.

		Debit	Credit
Other comprehensive income	Other gains and losses on remeasurement to fair value	1,500	
Asset	Available-for-sale financial assets		1,500

After the revaluation, the amount of losses in the other comprehensive income is as follows.

		Debit	Credit
	Cumulative balance in other comprehensive income		
	Other gains and losses on remeasurement to fair value, 2009		500
	Other gains and losses on remeasurement to fair value, 2010	1,500	
	Balance on 31 December 2010	1,000	

As X has established that the security is impaired, the cumulative related balance in other comprehensive income of 1,000 is reclassified to profit or loss on 31 December 2010.

		Debit	Credit
Profit or loss	Impairment loss	1,000	
Other comprehensive income	Impairment loss		1,000

On 31 December 2011 the fair value of the shares increased by 1,300 to 3,300. The full revaluation amount is recognised in other comprehensive income.

		Debit	Credit
Asset	Available-for-sale financial assets	1,300	
Other comprehensive income	Other gains and losses on remeasurement to fair value		1,300

6. Can realised gains and losses on financial assets at fair value through profit or loss be disclosed separately from unrealised ones?

Disclosure of realised gains and losses on financial assets at fair value through profit or loss is not required by IFRS, but is frequently made by investment funds. In general, realised gains and losses can be measured by comparing the sales proceeds with:

- the fair value at the beginning of the period (method 1 in the example below); or
- the original purchase price (method 2 in the example below).

Example 4 – Calculating realised gains and losses

On 30 September 2010 Fund X purchased shares in Company C for 3,000. The shares are classified as financial assets at fair value through profit or loss.

The fair value of the shares on 31 December 2010 was 3,500.

The shares were sold on 31 March 2011 for 3,150.

There are two possible ways of calculating realised gains and losses for the purpose of disclosure.

Disclosures as at 31 December 2011	Method 1	How calculated	Method 2	How calculated
	(350)	The sales price of 3,150 less the fair value on 31 December 2010 of 3,500	(350)	The sales price of 3,150 less the fair value on 31 December 2010 of 3,500
	-		500	The fair value on 31 December 2010 of 3,500 less the purchase price of 3,000
Total realised gains or losses	(350)		150	

If realised gains and losses are disclosed, then the measurement method should be disclosed in the accounting policy section of the financial statements and applied consistently.

Other KPMG publications

A more detailed discussion of the general accounting issues that arise from the application of IFRS can be found in our publication *Insights into IFRS*. In addition, we have a range of publications that can assist you further, including:

- Illustrative financial statements: Investment funds
- Illustrative financial statements for interim and annual periods
- IFRS compared to US GAAP
- IFRS Handbooks, which include extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard, including IFRS Handbook: First-time adoption of IFRSs
- New on the Horizon publications, which discuss consultation papers
- First Impressions publications, which discuss new pronouncements
- Newsletters, which highlight recent accounting developments
- IFRS Practice Issue publications, which discuss specific requirements of pronouncements
- Disclosure checklist.

IFRS-related technical information also is available at kpmg.com/ifrs.

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