Stage 1—Liabilities
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A Framework-based teaching approach to accounting for liabilities

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This material has benefited greatly from the feedback and comments from people attending a series of workshops on the Framework-based approach to teaching International Financial Reporting Standards (IFRS Standards) organised by the Foundation and others and from peer reviews by a number of anonymous reviewers.

Part 2: teaching material

Stage 1: teaching material

In this part we present teaching materials on accounting for liabilities that could be used in Stage 1 classes (for example, a first financial reporting course for CA/CPA stream students). The material includes:

- notes for students—explanations, examples and discussion questions relating to identification, recognition, measurement and derecognition of liabilities, and indications of some judgements and estimates in accounting for liabilities; and
- tutorial questions and suggested answers.

Stage 1: reference material

The following extracts from the Conceptual Framework and Standards (IFRS and the IFRS for SMEs Standards) provide students with the main concepts and principles relevant to accounting for liabilities. The authors envisage that students would have access to copies of these extracts in class and when they are being assessed. This open-book approach is consistent with focusing on developing students’ abilities to apply the requirements of the Standards, rather than having them learn and recite IFRS requirements and mechanically perform repetitive examples. An open-book approach is also more reflective of the ‘real world’ in which accountants must apply the Standards and analysts interpret the resulting financial statements, rather than recite its requirements. Furthermore, the requirements are likely to change over time and memorising the older versions of such material may not be helpful in future.
The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. IFRS 9 Financial Instruments, IAS 37 Provisions, Contingent Liabilities and Contingent Assets, Section 11 Basic Financial Instruments for the IFRS for SMEs and Section 21 Provisions and Contingencies of the IFRS for SMEs set out requirements for accounting for particular liabilities.

Extracts from the Conceptual Framework

Objective
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (paragraph OB2 of the Conceptual Framework). Other aspects of the Conceptual Framework (a reporting entity concept; the qualitative characteristics of, and the constraint on, useful financial information; elements of financial statements; recognition; measurement; presentation and disclosure) flow logically from the objective (see paragraph OB1 of the Conceptual Framework).

Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors’, lenders’ and other creditors’ expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity (see paragraph OB3 of the Conceptual Framework).

To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity’s resources. Examples of such responsibilities include protecting the entity’s resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management’s discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management’s actions (see paragraph OB4 of the Conceptual Framework).

General purpose financial reports
General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity’s economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity’s economic resources and claims. Both types of information provide useful input for decisions about providing resources to an
entity (paragraph OB12 of the Conceptual Framework). Furthermore, information about the entity’s cash flows also helps users to assess the entity’s ability to generate future net cash inflows (see paragraph OB20 of the Conceptual Framework).

Financial position
Information about the nature and amounts of a reporting entity’s economic resources and claims can help users to identify the reporting entity’s financial strengths and weaknesses. That information can help users to assess the reporting entity’s liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity (paragraph OB13 of the Conceptual Framework).

Financial performance
Information about a reporting entity’s financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors, is useful in assessing the entity’s past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors (paragraph OB18 of the Conceptual Framework).

Information about a reporting entity’s financial performance during a period may also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity’s economic resources and claims, thereby affecting the entity’s ability to generate net cash inflows (paragraph OB19 of the Conceptual Framework).

Qualitative characteristics
The qualitative characteristics of useful financial information [relevance, faithful representation, comparability, verifiability, timeliness and understandability] identify the types of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information) (see paragraph QC1 of the Conceptual Framework).

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent (paragraph QC4 of the Conceptual Framework). Relevant financial information is capable of making a difference in the decisions made by users (see paragraph QC6 of the Conceptual Framework). To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error (see paragraph QC12 of the Conceptual Framework).

The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable (paragraph QC4 of the Conceptual Framework).

1 Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both (see paragraph QC7 of the Conceptual Framework).
Additionally, the materiality of information must be considered. Information is material if omitting it or misstating it could influence decisions that users make on the financial information presented by an entity—materiality is an entity-specific aspect of relevance (see paragraph QC11 of the Conceptual Framework).

**Elements**

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the statement of financial position are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit or loss and other comprehensive income are income and expenses (paragraph 4.2 of the Conceptual Framework, with ‘statement of financial position’ substituted by the authors for ‘balance sheet’ and ‘statement of profit or loss and other comprehensive income’ substituted for ‘income statement’).

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (paragraph 4.4(b) of the Conceptual Framework). An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act in a certain way (paragraph 4.15 of the Conceptual Framework).

**Equity** is the residual interest in the assets of the entity after deducting all its liabilities. (paragraph 4.4(c) of the Conceptual Framework).

**Income** is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants (paragraph 4.25(a) of the Conceptual Framework).

**Expenses** are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants (paragraph 4.25(b) of the Conceptual Framework).

**Extracts from IFRS 9 & IAS 37 and Sections 11 & 21 of the IFRS for SMEs**

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<td>A <strong>financial liability</strong> is any liability that is:</td>
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**A contingent liability** is:
(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
(b) a present obligation that arises from past events but is not recognised because:
   (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
   (ii) the amount of the obligation cannot be measured with sufficient reliability.
(Paragraph 10 of IAS 37)

**Initial recognition**

An entity shall recognise … a **financial liability** in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument…
(Paragraph 3.1.1 of IFRS 9 with emphasis added)

**Measurement**

At initial recognition, an entity shall measure a … **financial liability** at its fair value … minus … transaction costs that are directly attributable to the … issue of the … financial liability. In many cases the transaction price will equal the fair value…
(Paragraph 5.1.1 of IFRS 9 and paragraph 58 of IFRS 13 with emphasis added)

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<td><strong>An entity shall classify all financial liabilities as subsequently measured at amortised cost using the effective interest method …</strong> (paragraph 4.2.1 with emphasis added)</td>
<td><strong>Debt instruments … shall be measured at amortised cost using the effective interest method.</strong> (paragraph 11.14 with emphasis added)</td>
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| **Amortised cost** is the amount at which the … financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount… (IFRS 9 Appendix A with emphasis added) | **The amortised cost of a … financial liability at each reporting date is the net of the following amounts:**  
(a) the amount at which the … financial liability is measured at initial recognition,  
(b) minus any repayments of the principal,  
(c) plus … the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount,  
(paragraph 11.15 with emphasis added) |
| **The effective interest method** is used in the calculation of the amortised cost of…a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. (IFRS 9 Appendix A with emphasis added) | ….The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the … financial instrument … to the carrying amount of the … financial liability. (paragraph 11.16 with emphasis added) |
| **The amount recognised as a provision shall be …**the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. (paragraphs 36 and 37 of IAS 37 with emphasis added) | **An entity shall measure a provision at … the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.** (paragraph 21.7 with emphasis added) |
| **Provisions** shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. (paragraph 59 of IAS 37 with emphasis added) | **An entity shall review provisions at each reporting date and adjust them to reflect the current best estimate of the amount that would be required to settle the obligation at that reporting date. Any adjustments to the amounts previously recognised shall be recognised in profit or loss…** (paragraph 21.11 with emphasis added) |

**Other**

In addition to the above, an entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS or by another part of the IFRS for SMEs (see paragraph 32 of IAS 1 Presentation of Financial Statements and paragraph 2.52 of the IFRS for SMEs).
**Stage 1: notes for students**

The notes below are set out under headings that loosely follow what is sometimes described as the ‘financial reporting process’:

- **Identifying liabilities**—this section introduces the question—what is a liability? It aims to develop students’ abilities to differentiate items that obviously satisfy the definition of a liability from those that obviously do not.

- **Useful information about liabilities**—consistently with the objective of IFRS financial information this section aims to focus students’ mindset on the information needs of primary users (ie potential and existing investors, lenders and other creditors that cannot require the reporting entity to provide information directly to them) in making decisions about providing resources to the entity (for example, whether to buy, hold or sell shares in the entity).

- **Classification of liabilities**—this section aims to develop students’ understanding of why liabilities (and assets) are sub-classified and to start developing their ability to differentiate between basic IFRS sub-classifications of liabilities.

- **Recognition of liabilities**—the aim of this section is to start developing students’ understanding of the criteria that must be satisfied to recognise particular IFRS liabilities.

- **Measurement of liabilities**—the aim of this section is to provide students with a basic understanding of the measurements for a selection of IFRS liabilities.

- **Estimates and judgements**—the aim of this section is to raise students’ awareness of some of the estimates and judgements in accounting and reporting liabilities in accordance with IFRS.

**Identifying liabilities**

A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (paragraph 4.4(b) of the *Conceptual Framework*).

Virtually all entities will, at some stage, have liabilities recognised in their statement of financial position. The types of liabilities recognised will vary, based on the entities’ capital structure, nature of operations and on events that may often be unforeseen (for example, an unexpected event that results in the entity defending a lawsuit).

In many cases it is not difficult to identify liabilities. Firstly, one should determine whether the entity has a *present obligation* (for example, a contractual obligation) and then determine whether that obligation is expected to result in an outflow of resources embodying economic benefits (for example, cash).

Note: the examples that follow are relatively straightforward. As students move to Stage 2, the examples become more complex and the exercise of judgement is necessary.
Example 1: trade payables

On 1 December 20x1 a bookshop (book retailer) decides to place an order for 1,000 books from a supplier for the purpose of resale to the bookshop’s customers in the ordinary course of business.

On 10 December 20x1 the bookshop orders the books from the supplier. The order is fully cancellable—the bookshop can nullify the order at any time before it accepts delivery of the books from the supplier.2

On 20 December 20x1, the bookshop takes delivery of 1,000 books from a supplier. Although the terms of the contract with the supplier require payment only 14 days after delivery, legal title3 and control of the books passes from the supplier to the bookshop when the bookshop takes delivery of the books.

In accordance with the agreed terms, the bookshop pays the supplier the full amount owed on 3 January 20x2 (ie two weeks after the books were delivered to the bookshop).

When does the bookshop first have a liability to its supplier?

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (see paragraph 4.4(b) of the Conceptual Framework).

Consequently, answering the question—when does the bookshop first have a liability to its supplier for the 1,000 books?—requires determining when the bookshop first becomes obliged to pay the supplier for those books. In other words, answering the question requires identifying the event that obliges the bookshop to pay the supplier for the 1,000 books (sometimes called the obligating event).

Is making the decision to order the books the obligating event? No, the bookshop’s decision to order books does not oblige it to pay the supplier for those books. At this time the bookshop can avoid paying the supplier for the books by, for example, not ordering the books. Conclusion—at 1 December 20x1 the bookshop does not have a liability to the supplier for books that it has decided to order.

Is placing the order the obligating event? No, the bookshop’s decision to order 1,000 books does not oblige it to pay the supplier for those books. At this time the bookshop can still avoid paying the supplier for the books by, for example, cancelling the order. Conclusion—at 10 December 20x1 the bookshop does not have a liability to the supplier for 1,000 books ordered.

Is taking delivery of the books the obligating event? Yes, the bookshop’s action of taking delivery of the 1,000 books obliges it to pay the supplier for those books—the bookshop now cannot avoid paying the supplier for the books. Conclusion—from the time of taking delivery of the books on 20 December 20x1 until paying its supplier the full amount owed on 3 January 20x2, the bookshop has a liability to pay the supplier for the 1,000 books received.

2 Note to teachers: in later Stages we will explore when a liability first arises in respect of wholly unperformed executory contracts (eg, an uncancellable contract for the purchase of a non-financial asset).

3 in other words, ownership of the inventory in accordance with the law.
**Example 2: long-term loan and interest accreted**

On 1 January 20x1, in order to fund further expansion of the business, an entity borrows CU1,000,000\(^4\) from a bank at market rates—the loan must be repaid in ten equal yearly instalments of CU100,000 commencing on 1 January 20x2. In addition to the principal repayments, the loan agreements specifies that the entity must pay, in arrears on 1 January each year, interest at a rate of 5 per cent per year on the outstanding loan.

The first question—at 31 December 20x1 is the CU1,000,000 loan outstanding a liability of the entity?

By taking receipt of the proceeds of the CU1,000,000 loan in accordance with the loan agreement (obligating event) on 1 January 20x1, the entity incurs a present obligation to repay the loan in ten equal instalments (outflow of economic benefits).

Conclusion—at 31 December 20x1 the principal amount of the loan outstanding (CU1,000,000) is a liability of the entity.

The second question—at 31 December 20x1, is the CU50,000 accreted interest a liability of the entity?

At 31 December 20x1 the entity is obliged (a present obligation) in accordance with the terms of the loan agreement that it is subject to (obligating event) to pay CU50,000 interest to the lender for the 12 months to 31 December 20x1 that the entity has accessed the lender’s CU1,000,000—ie 5 per cent × CU1,000,000. Paying the lender CU50,000 on 1 January 20x2 will result in an outflow of economic benefits from the entity.

Conclusion—at 31 December 20x1 the CU50,000 interest payable to the lender is a liability to the entity.

**Example 3: lawsuit**

Waste from an entity’s production process contaminates the groundwater at the entity’s plant. In a lawsuit brought against the entity, members of the local community seek compensation for damage to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. The ruling is expected in mid-20x2 and the compensation awarded by the court is expected to be in the range CU1 million–CU300 million.

At 31 December 20x1 does the entity have a liability?

At 31 December 20x1 the entity has a present legal obligation (it is obliged to compensate the local community) for contaminating the groundwater (past event) as a result of which cash (somewhere in the range CU1 million–CU300 million) is expected to flow from the entity.

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\(^4\) In this example, and in all other examples in this material, monetary amounts are denominated in ‘currency units (CU)’. 

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Conclusion
At 31 December 20x1 the present legal obligation to compensate the local community is a liability of the defendant even though the court is still deciding on the amount of the damages. The existence of the liability is not undermined by the significant uncertainty about the amount that the court will award the claimants.\(^5,6\)

Example 4: rental income received in advance
An entity generates income by renting out a warehouse. On 1 December 20x1 the tenant pays rental for the use of the warehouse for the next 12 months (ie payments are made to the entity in advance).

At 31 December 20x1 is the amount received in advance by the entity a liability?
Taking receipt of the 12-month payment in advance from the tenant, on 1 December 20x1, obliges the entity (a present obligation) to make the warehouse available to the tenant for the next twelve months (expected outflows of future economic benefits from the entity).

At 31 December 20x1 the entity still has a liability because it remains obliged to make the warehouse available to the tenant for the next eleven months.\(^7\)

Conclusion
At 31 December 20x1 the entity has a present obligation (a liability) to make the warehouse available to the tenant for the next eleven months.

Example 5: employee benefits
On 1 January 20x2 an entity paid one of its employees CU1,000 for work performed under contract of employment in December 20x1.

At 31 December 20x1 does the entity have a liability?
At 31 December 20x1 the entity has a present obligation to pay the employee CU1,000 for work performed under contract (obligating event).\(^8\) Settlement of the obligation is expected to result in the outflow of CU1,000 (economic benefits).

\(^5\) Note to teachers: in later Stages we will explore when a liability first arises in respect of events that are the subject of court cases.
\(^6\) When a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated (see paragraph 4.19 of the Conceptual Framework and paragraph 25 of IAS 37 Provisions, Contingent Liabilities and Contingent Assets).
\(^7\) However, as the tenant has occupied the warehouse for one month (December 20x1), the liability is reduced by 1 month (ie now only 11 months of the original 12-month obligation remain) and this decrease in the liability is income of the entity in December 20x1 (see paragraph 4.25(a) of the Conceptual Framework).
\(^8\) Note to teachers: in this example we have assumed that the employee benefit vested in 20x1. In later Stages we will explore when a liability first arises in respect of accumulating but unvested employee benefits (for example, a ten-year long service award that is conditional upon the employee remaining in the service of the entity for a further nine years).
Conclusion

At 31 December 20x1 the obligation to compensate the employee for services rendered in 20x1 (CU1,000) is a liability of the entity.

Useful information about liabilities

To provide context for class discussion of useful information about liabilities, teachers could refer students to the objective and qualitative characteristics chapters of the Conceptual Framework (possibly using the extracts provided above). In doing so, students will also be reminded of the importance of looking at the ‘full picture’ rather than viewing liabilities in isolation.

Relevant (ie capable of making a difference to the decisions made by users) and faithfully represented (ie information that is complete, neutral and free from error) information about an entity’s liabilities is likely to be useful to primary users—existing and potential investors, lenders and other creditors who cannot require information directly from the entity—when making decisions about the reporting entity. Providing relevant and faithfully represented information about an entity’s liabilities in accordance with IFRS and the IFRS for SMEs often requires judgement.

To facilitate class discussion regarding what information about an entity’s liabilities, and any changes in those liabilities, would be useful to primary users—existing and potential investors and creditors who cannot require information directly from the entity—a teacher could ask questions such as:

What is the economic rationale for incurring liabilities? In other words, why do manufacturers take out loans from banks, why do retailers not pay their suppliers immediately and why do airlines take payment in advance from customers?

What information about an entity’s liabilities would be capable of making a difference when:

- existing and potential investors make decisions about buying, selling or holding equity and debt instruments; and
- lenders and other creditors make decisions about providing or settling loans and other forms of credit?

Personalising the questions further can also help foster discussion. For example, by asking—if you were considering buying shares in an entity that had significant liabilities—what information about that entity’s liabilities would you find most useful in assessing the entity’s prospects for future net cash inflows?

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9 Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (paragraph OB2 of the Conceptual Framework).
Consistently with the manner in which the IASB sets IFRS, once the students have formulated their views on the questions above, the next question the teacher might want to ask the class to discuss is—can the information be faithfully represented (i.e., the information is complete, neutral and free from error)?

**Classification of liabilities**

Paragraphs OB13 and OB14 of the *Conceptual Framework* emphasise the usefulness of classifying liabilities (and assets)—this information “can help users to identify the reporting entity’s financial strengths and weaknesses… can help users to assess the reporting entity’s liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity”.

Paragraph 54 of IAS 1 specifies minimum line items (classifications) for presentation in the statement of financial position. Moreover, an entity is required to make the judgement about whether to present additional items separately on the basis of an assessment of, among other things, the amounts, nature and timing of liabilities (see paragraph 58 of IAS 1).

Notwithstanding that examples 1–5 include other classifications of liability (for example, employee benefits) the remainder of these notes on liabilities at Stage 1 are limited to three classifications of liability—financial liabilities, provisions and contingent liabilities.

Using the definitions provided in the extracts above, teachers could lead a discussion about the classification of the liabilities in the examples that follow.

**Example 6: trade payables**

The facts are the same as in Example 1. At 31 December 20x1 a bookshop (book retailer) owes a book supplier CU10,000 for 1,000 books received from the supplier. The terms of the contract with the supplier requires payment on 3 January 20x2 (14 days after delivery which occurred on 20 December 20x1), with legal title and control of the books passing from the supplier to the bookshop when the bookshop takes delivery of the books.

Which IFRS classification of liability is the trade payable?

The bookshop has a financial liability—it has a contractual obligation to deliver CU10,000 cash to its supplier.

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10 The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity’s financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information. (Paragraph QC18 of the *Conceptual Framework*.)
**Example 7: long-term loan and interest accreted**

The facts are the same as in Example 2. At 31 December 20x1 the entity owes the bank CU1,050,000 (CU1,000,000 original loan plus CU50,000 accreted interest). The CU1,000,000 principal of the loan must be repaid in ten equal yearly instalments of CU100,000 commencing on 1 January 20x2. In addition to the principal repayments, the loan agreements specify that the entity must pay, in arrears on 1 January each year, interest at a rate of 5 per cent per year on the outstanding loan.

*Which IFRS classification of liability is the loan?*

The entity has a financial liability—it has a contractual obligation to deliver CU1,000,000 cash to the bank.

*Which IFRS classification of liability is the accreted interest?*

The entity has a financial liability—it has a contractual obligation to deliver CU50,000 cash to the bank.

**Example 8: lawsuit**

The facts are the same as Example 3. Waste from an entity’s production process contaminates the groundwater at the entity’s plant. In a lawsuit brought against the entity, members of the local community seek compensation for damages to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. The ruling is expected in mid-20x2 and the compensation awarded by the court is expected to be in the range CU1 million–CU300 million.

*Which IFRS classification of liability is the lawsuit obligation?*

The entity has a provision—both the timing (although the ruling is expected in mid-20x2, it might not occur at that time) and the amount of the liability (damages are expected to be in the range CU1 million–CU300 million) are uncertain.

Teachers could use this example to raise awareness of one of the judgements in classifying liabilities by bringing paragraph 25 of IAS 37 to the attention of their students. That paragraph clarifies—“The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.” In such extremely rare cases, the entity would classify the liability as a contingent liability. In Example 8 the entity is able to determine a range of possible outcomes, and therefore it must classify this liability as a provision.
Recognition of liabilities

In most cases it is easy to determine when to recognise a liability (in other words, when to include it in the entity’s statement of financial position).

Although the Conceptual Framework sets out recognition criteria, the recognition of a liability is determined by the particular IFRS that applies to that liability (for example, IFRS 9 Financial Instruments for financial liabilities and IAS 37 Provisions, Contingent Liabilities and Contingent Assets for provisions).

Paragraph 3.1.1 of IFRS 9 specifies that a financial liability is recognised in the statement of financial position when the entity becomes party to the contractual provisions of the instrument. In other words, for financial liabilities the Conceptual Framework recognition criteria are presumed to be satisfied at this point in time.

Consistently with the recognition criteria specified in the Conceptual Framework, IAS 37 specifies that a provision (liability) is recognised when:

(a) it is probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation; and

(b) a reliable estimate can be made of the amount of the obligation (see paragraph 14 of IAS 37 and paragraphs 4.38 and 4.46 of the Conceptual Framework).

For the purposes of applying the first recognition criterion in IAS 37, paragraph 23 specifies “probable” to mean “more likely than not” (in other words, greater than 50 per cent).

For provisions, the second recognition criterion—that cost can be reliably measured—is usually satisfied when the obligation first meets the definition of a liability. As set out above, except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision (see paragraph 25 of IAS 37).

Example 9: trade payables

The facts are the same as in Examples 1 and 6. On 20 December 20x1, the bookshop takes delivery of 1,000 books from a supplier. The terms of the contract with the supplier require payment in full (CU10,000) on 3 January (14 days after delivery). Legal title and control of the books passed from the supplier to the bookshop when the bookshop took delivery of the books.

When does the bookshop first recognise the trade payable?

In accordance with paragraph 3.1.1 of IFRS 9 the bookshop would first recognise the financial liability (see Example 6 above) on 20 December 20x1 when it becomes party to the contractual provisions of the non-cancellable contract (such contracts often take the form of an invoice accompanied by a delivery note) that arises from accepting delivery of the 1,000 books.
Example 10: long-term loan and interest accreted

The facts are the same as in Examples 2 and 7. On 1 January 20x1, in order to fund further expansion of the business, an entity borrows CU1,000,000 from a bank at market rates—the loan must be repaid in ten equal yearly instalments of CU100,000 commencing on 1 January 20x2. In addition to the principal repayments, the loan agreement specifies that the entity must pay, in arrears on 1 January each year, interest at a rate of 5 per cent per year on the outstanding loan.

At 31 December 20x1 the entity owes the bank CU1,050,000 (CU1,000,000 loan plus CU50,000 accreted interest).

When does the entity first recognise a liability for the loan?

In accordance with paragraph 3.1.1 of IFRS 9, the entity would first recognise a financial liability (see Example 7 above) for the principal amount of the loan on 1 January 20x1 when it simultaneously becomes party to the contractual provisions of the loan agreement and receives CU1,000,000 from the bank.

When does the entity first recognise a liability for the accreted interest?

In accordance with paragraph 3.1.1 of IFRS 9 the entity would recognise a financial liability (see Example 7 above) for the interest accreted as that liability accretes during 20x1 (ie over time).

Example 11: lawsuit

The facts are the same as Examples 3 and 8. Waste from an entity’s production process contaminates the groundwater at the entity’s plant. In a lawsuit brought against the entity, members of the local community seek compensation for damages to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. The ruling is expected in mid-20x2 and the compensation awarded by the court is expected to be in the range CU1 million–CU300 million.

When does the entity first recognise a liability for the lawsuit?

In accordance with paragraph 14 of IAS 37, the entity first recognises a liability (provision) when it becomes more likely than not that it will compensate the community for damage to their health caused by the entity contaminating the groundwater and a reliable estimate can be made of the amount of that compensation. Judgement will be required in determining when both of the recognition criteria are satisfied. However, by 31 December 20x1 both the recognition criteria are satisfied. Consequently, at 31 December 20x1 the entity must recognise a liability (provision) for the lawsuit in its statement of financial position.

Teachers could use this example to raise awareness of judgement when recognising liabilities.
Measurement of liabilities

The measurement of a liability is determined by the particular IFRS that applies to that liability (for example, IFRS 9 for financial instruments and IAS 37 for provisions). IAS 37 specifies that a liability must be measured at the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

To a large extent, financial reports are based on estimates, judgements and models rather than being exact depictions (paragraph OB11 of the Conceptual Framework). For the liabilities addressed in the Stage 1 material, there are few estimates and judgements to be made. For example, in Example 13, the fair value of the bank loan when first recognised is equal to the cash received from the bank (in other words, the transaction price). However, Example 12 introduces uncertain future cash flows. Applying IAS 37’s measurement principle to uncertain future cash flows requires the use of judgement and estimates. Those and other issues that require judgement are explored further at Stage 2.

Example 12: lawsuit

The facts are the same as Examples 3, 8 and 11. On the basis of risk-adjusted awards granted in similar lawsuits in the same jurisdiction, the entity establishes that at the reporting date (31 December 20x1) it has a 30 per cent chance of being ordered to pay the customer compensation of CU1 million and a 70 per cent chance of being ordered to pay compensation of CU300 million. The ruling is expected to take place in mid 20x2.

At what amount should the entity measure its liability for the lawsuit at 31 December 20x1?

At 31 December 20x1 the risk-adjusted outcome of the lawsuit is rationally expected to be a cash outflow of either CU1 million or CU300 million. One way in which the entity could estimate the amount required to settle the obligation at the reporting date (31 December 20x1) is to use an expected value approach to measure the liability. Using this approach, at 31 December 20x1 it could measure the liability at the risk-adjusted expected value of CU210,300,000 (ie 30% × CU1,000,000 + 70% × CU300,000,000).11

Example 13: borrowing

On 1 January 20x1 in order to fund further expansion of the business, an entity borrowed CU1,000,000 from a bank. In accordance with the loan agreement the entity received CU1,000,000 from the bank on 1 January 20x1 and must, on 31 December 20x2, in full and final settlement of the loan, transfer CU1,210,000 to the bank.

At 31 December 20x1 at what amount must the entity measure its liability to the bank?

In accordance with IFRS 9 the loan liability must be measured at amortised cost. The effective interest rate can be calculated using the ‘Internal Rate of Return’ (IRR) formula using a Microsoft Excel® spreadsheet. The formula is presented in a shaded box.

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11 In this example, the effects of the time value of money are ignored because they are judged to be immaterial.
Cash flows

<p>| | |</p>
<table>
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<tr>
<td>1</td>
<td>Cash flows</td>
</tr>
<tr>
<td>2</td>
<td>1,000,000</td>
</tr>
<tr>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>-1,210,000</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Effective rate = \text{IRR}(B2:B4,)</td>
</tr>
</tbody>
</table>

In cell B6 ‘B2:B4’ identifies the cash flow values presented in cells B2 to B4. The comma indicates that we have not estimated the effective interest rate. Cell B6 computes an IRR (effective interest rate) of 0.1 (ie 10 per cent compounded annually).

The effective interest rate (10 per cent) multiplied by the amount of the liability at initial recognition (CU1,000,000) is added to the initial amount (CU1,000,000) to arrive at the carrying amount of the liability (CU1,100,000 amortised cost) at 31 December 20x1.

In other words, the CU100,000 interest that accretes on the loan during 20x1 is included in the carrying amount of the loan at 31 December 20x1 because it is unpaid.

**Conclusion**

At 31 December 20x1 the entity would measure the loan liability at CU1,100,000 (ie the present value of the cash flow (CU1,210,000) to be made on 31 December 20x2, discounted for 12 months using the effective interest rate).

Note: the following journal entries would record the loan in the entity’s general ledger over its two year term:

**1 January 20x1**

Debit Asset—financial asset: cash CU1,000,000\(^{12}\)
Credit Liability—financial liability: bank loan CU1,000,000

To recognise the obligation to repay the cash received from the bank

**For the year ended 31 December 20x1**

Debit Expense—profit or loss: finance cost CU100,000\(^{13}\)
Credit Liability—financial liability: bank loan CU100,000

To recognise the obligation to pay the interest accreted on the bank loan in 20x1

**For the year ended 31 December 20x2**

Debit Expense—profit or loss: finance cost CU110,000\(^{14}\)
Credit Liability—financial liability: bank loan CU110,000

To recognise the obligation to pay the interest accreted on the bank loan in 20x2

**31 December 20x2**

Debit Liability—financial liability: bank loan CU1,210,000
Credit Asset—financial asset: cash CU1,210,000\(^{15}\)

To recognise the settlement of the obligation by repaying the bank loan

\(^{12}\) Cash inflow from bank loan

\(^{13}\) CU1,000,000 bank loan \times 10\% = CU100,000 finance cost

\(^{14}\) (CU1,000,000 initial bank loan + CU100,000 finance cost accreted) \times 10\% = CU110,000 finance cost

\(^{15}\) Cash outflow to settle the bank loan
Estimates and Judgements

Providing relevant information about an entity’s liabilities requires estimates and judgements—often to a large extent, financial reports are based on estimates, judgements and models rather than being exact depictions of reality (see paragraph OB11 of the Conceptual Framework). Following are some aspects of accounting for liabilities where judgement is required. These and other issues that require judgement are explored further at Stage 2.

Judgement—existence of a liability

In most cases it will be clear whether a past event has given rise to a present obligation. However, for example, in some lawsuits, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, determining whether a present obligation exists at the end of the reporting period requires taking account of all available evidence, often including the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period.

Judgement—recognition of liabilities

Significant uncertainty exists for some liabilities—for example, the cost or value of a liability of uncertain timing or amount (i.e., a provision) has inherent uncertainties (for example, see Example 11 above). Those uncertainties may make it more difficult for an entity to determine an amount to recognise and in such cases estimates may need to be made. It is important to remember that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability (see paragraph 4.41 of the Conceptual Framework). Consequently, such estimates do not prevent recognition of an item as a provision.

Judgement—measurement of liabilities

Significant uncertainty exists with respect to the measurement of particular liabilities—for example, the timing and amount of the expected cash flows in Example 12. Those uncertainties may result in greater difficulty for an entity to determine amounts at which to measure liabilities and in such cases estimates will need to be made. However, it is important to remember that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability (see paragraph 4.41 of the Conceptual Framework).
Stage 1: tutorial question 1 on accounting for liabilities

Entity A operates organic vegetable storage facilities in Country X. Recently enacted legislation in Country X requires that all organic vegetable storage facilities must install specialised air filtration and conditioning systems by July 20x9. Facilities failing to comply with these regulations will incur a fine of CU10,000 per facility and their operating licences will be suspended for one month. Strict enforcement of the legislation will be undertaken by a new division of Country X’s agriculture department.

Entity A owns five storage facilities and had not complied with the legislation (ie had not installed the specialised air filtration and conditioning systems) by the end of its financial year, 30 September 20x9. Furthermore, no inspection of their facilities had been made by 30 September 20x9.

Part A:
At 30 September 20x9, does Entity A have an obligation relating to the purchase and installation costs of the new specialised air filtration and conditioning systems?

Part B:
At 30 September 20x9, does Entity A have an obligation relating to its failure to comply with the new legislation and any potential fine?

Part C:
Discuss how (if at all) your answers to Parts A and B would change if an inspection had been conducted by the agriculture department on 29 September 20x9 and Entity A was found to be in contravention of the legislation at that date.
Stage 1: suggested answer to tutorial question 1 on accounting for liabilities

Part A:
At 30 September 20x9, does Entity A have an obligation relating to the purchase and installation costs of the new specialised air filtration and conditioning systems?

At 30 September 20x9, Entity A has not incurred any costs relating to the installation of specialised air filtration and conditioning systems—the entity has not purchased or installed the systems.

In this situation, the legal obligation to install such systems does not give rise to a liability because Entity A can avoid the future expenditure by its future actions, for example, by ceasing to store organic vegetables at its facilities.

Likely conclusion
Because Entity A has no present obligation for that future expenditure, no liability (as defined) exists at 30 September 20x9.

Part B:
At 30 September 20x9, does Entity A have an obligation relating to its failure to comply with the new legislation and any potential fine?

At 30 September 20x9, it is clear that Entity A is in contravention of the legislation—this is a past event that leads to the entity having a present obligation. Such a contravention, if discovered, would lead to a fine being imposed upon the entity. Settlement of that fine would involve the outflow of cash (economic benefits).

While no inspection has been conducted and, therefore, the contravention had not been discovered by 30 September 20x9, it is likely that there will be an outflow of benefits in the form of the payment of the fine because there is a strict enforcement regime in place—it is more likely than not that the entity’s failure to comply will be discovered.

Likely conclusion
A liability (provision) is recognised for fines and penalties—they are more likely than not to be imposed.

Note
Assessing the probability of incurring the fine depends on the details of the legislation and the stringency of the enforcement regime. For example, the likely conclusion is based on the entity being fined for its failure to comply as at 30 September 20x9 regardless of whether the entity had ceased operating organic vegetable storage facilities. If, on the other hand, the entity was able to avoid a fine by ceasing operations, then there is no obligating event (no present obligation) and therefore no liability.16

16 Although this does assume that there is no backdating of penalties in Country X in relation to this legislation.
Part C:
Discuss how (if at all) your answers to Parts A and B would change if an inspection had been conducted by the agriculture department on 29 September 20x9 and Entity A was found to be in contravention of the legislation.

An inspection being conducted would have the following effects:

Part A:
No effect. The inspection would not change the fact that no past event relating to the purchase and installation of the systems has occurred and, therefore, no present obligation for the entity exists.

Part B:
Because the contravention of the legislation would most likely have been discovered during the investigation, Entity A will most likely be fined. Consequently, the outflow of economic benefits associated with paying the fine is highly probable. Furthermore, the amount of the outflow is reliably measurable (CU10,000 per facility).

Likely conclusion—Entity A must recognise a liability for the fine in its statement of financial position at 30 September 20x9.

Note: at 30 September 20x9 Entity A cannot recognise a liability for the loss of future profits resulting from the highly likely suspension of its operating licences for one month—the losses will only be incurred in the future and hence no related present obligation exists.
Stage 1: Tutorial question 2

On 1 January 20x1, in order to fund further expansion of the business, Entity A borrowed CU1,000,000 from an independent third party. In accordance with the loan agreement, Entity A received CU1,000,000 from the third party on 1 January 20x1 and must, on 31 December 20x3, in full and final settlement of the loan, transfer CU1,000,000 to the third party. In addition to this payment, the entity must pay CU120,000 to the third party on both 31 December 20x2 and 31 December 20x3 as interest on the amount borrowed. No interest is payable on 31 December 20x1.

Part A:
At 31 December 20x1, does Entity A have a present obligation relating to the loan from the bank?

Part B:
Calculate the effective interest rate implicit in the loan contract.

Part C:
Prepare the journal entries necessary to record the loan in the entity’s general ledger over its three-year term.
Stage 1: suggested answer to tutorial question 2 on accounting for liabilities

Part A:
At 31 December 20x1, does Entity A have a present obligation relating to the loan from the bank?
Yes, at 31 December 20x1, it is clear that Entity A has a present obligation arising from borrowing money from the bank that gives rise to a contractual obligation to repay both the loan and the interest accreted on the loan. Settlement of the loan (including the accreted interest) will involve the outflow of cash (economic benefits).

Part B:
Calculate the effective interest rate implicit in the loan contract.
The effective interest rate can be calculated using the ‘Internal Rate of Return’ (IRR) formula using a Microsoft Excel® spreadsheet. The formula is presented in a shaded box.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
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<tbody>
<tr>
<td>1</td>
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<tr>
<td>7</td>
<td>Effective rate =IRR(B2:B5)</td>
</tr>
</tbody>
</table>

In cell B7 ‘B2:B5’ identifies the cash flow values presented in cells B2 to B5. The comma indicates that we have not estimated the effective interest rate. Cell B7 computes an IRR (ie effective interest rate) of 0.077 (ie 7.7 per cent)—this rate has been rounded.

Part C:
Prepare the journal entries necessary to record the loan in the entity’s general ledger over its three-year term.
The following journal entries would record the loan in the entity’s general ledger over its three-year term:

1 January 20x1
Debit Asset—financial asset: cash CU1,000,000
Credit Liability—financial liability: bank loan CU1,000,000
To recognise the obligation to repay the cash received from the third party.

31 December 20x1
Debit Expense—profit or loss: finance cost CU77,000
Credit Liability—financial liability: bank loan CU77,000
To recognise the obligation to pay the interest accreted on the loan in 20x1.
Note: no cash payment is made on 31 December 20x1.

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31 December 20x2
Debit  Expense—profit or loss: finance cost  CU82,929
Credit  Liability—financial liability: bank loan  CU82,929
To recognise the obligation to pay the interest accreted on the loan in 20x2.

Debit  Liability—financial liability: bank loan  CU120,000
Credit  Asset—financial asset: cash  CU120,000
To recognise the payment of interest on the loan

31 December 20x3
Debit  Expense—profit or loss: finance cost  CU80,075
Credit  Liability—financial liability: bank loan  CU80,075
To recognise the obligation to pay the interest accreted on the loan in 20x3

Debit  Liability—financial liability: bank loan  CU1,120,000
Credit  Asset—financial asset: cash  CU1,120,000
To recognise the settlement of the obligation by repaying the loan and interest for 20x3

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19 (CU1,000,000 initial loan + CU77,000 finance cost accreted) × 7.7% = CU82,929 finance cost
20 Cash outflow to settle the annual interest
21 (CU1,000,000 initial loan + (CU77,000 + CU82,929) finance costs accreted – CU120,000 payment made) × 7.7% = CU80,075 finance cost
22 Cash outflow to settle the annual interest and loan amount

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