

## Financial Instruments

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This article is designed to clarify and illustrate the requirements of IAS 32, IAS 39, IFRS 7 and IFRS 9 in so far as they are examinable on the P1 Corporate Reporting examination. It will also be of interest to students of P2 Advanced Corporate Reporting.

### Introduction:

The issue of financial instruments is an extremely topical one in financial reporting. The accounting requirements in this area have been subjected to detailed scrutiny since the recent financial crisis commenced. Some commentators have blamed fair value accounting rules for exacerbating the crisis. Fair value is defined as market value essentially, and during the crisis the market for certain financial instruments dried up. This meant that any transactions were at distressed prices, and using these prices to value a portfolio of similar investments led to massive write-offs, and therefore losses, in the financial statements of institutions holding them.

Part of the problem is that financial instruments have become increasingly complex in recent years, and accounting requirements have not kept up with the pace of innovation in this sector of the economy. A further problem is that the market for financial instruments is global, and the accounting requirements are not yet harmonised globally. This can lead to the same instruments being valued in different ways in different countries, depending on the accounting rules being followed by the entity accounting for them. As a result, entities may choose to locate wherever the accounting rules are less restrictive, leading to “regulatory arbitrage”. Countries are therefore reluctant to implement rules that are stricter than those in other countries as they may lose financial businesses, and as a result capital and employment, to countries with less onerous standards. Consequently, a strenuous effort is being made to agree global standards in the area of accounting for financial instruments.

The IASB has several extant standards in this area. These are as follows:

- IAS 32 *Financial Instruments: Presentation* covers the definitions and presentation of financial instruments in the financial statements, mainly governing the categorisation of instruments between assets, liabilities and equity.
- IAS 39 *Financial Instruments: Recognition and Measurement* covers the recognition and measurement of financial instruments. This issue here is when to recognise and derecognise an instrument in the financial statements, and also what value to place on the instrument once it has been decided to recognise it. This standard is in the process of being replaced by IFRS 9.
- IFRS 7 *Financial Instruments: Disclosures* covers the disclosure requirements for financial instruments.
- IFRS 9 *Financial Instruments* is a work-in-progress standard designed to clarify and simplify the requirements of IAS 39. It is being developed in 3 phases. Phase 1 (classification and measurement) was issued in November 2009 and amended in October 2010. The remaining phases are not complete yet. It will completely replace IAS 39. IFRS 9 is a joint project between the IASB and the Financial Accounting Standards Board in the USA.

For further information on IASB projects, please visit [www.iasb.org](http://www.iasb.org).

Access to accounting standards is free of charge, but registration is required.

## **IAS 32 Financial Instruments - Presentation**

The objective of this standard is to establish principles for classifying financial instruments into the headings financial assets, financial liabilities and equity instruments. It also gives definitions for some important terms in this area.

### Definition 1: financial instrument

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

### Definition 2: financial asset (simplified)

A financial asset is any asset that is:

- cash; or
- an equity instrument of another entity; or
- a contractual right:
  - (i) to receive cash or another financial asset from another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.

### Definition 3 : financial liability (simplified)

A financial liability is any liability that is a contractual obligation:

- (i) to deliver cash or another financial asset to another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

### Definition 4: equity instrument

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

### Further issues

Interest, dividends, losses and gains relating to a financial instrument that is a financial liability shall be recognised as income or expense within profit or loss.

Note that preference shares are considered to be an equity instrument only if they are non-cumulative and non-redeemable. If the preference shares are cumulative, meaning that any dividend accumulates until paid, then this meets the definition of a financial liability. The same applies if the preference shares are redeemable, meaning that there is an obligation on the entity to repay them at some point. Therefore such shares are classified as liabilities. Any dividends on these shares are classified as finance costs within profit or loss.

Distributions to holders of an equity instrument (e.g. equity dividends) shall be debited by the entity directly to equity. This implies that dividends to ordinary shareholders do not appear on the face of the statement of comprehensive income, but rather as a deduction from equity, normally shown in the statement of changes in equity. Transaction costs of an equity transaction (e.g. issue costs for new equity shares) shall be accounted for as a deduction from equity, net of any related income tax benefit.

## **IAS 39 & IFRS 9: Recognition & Measurement Issues**

The objective of these standards is to establish principles for recognising and measuring financial assets and financial liabilities. Note that all the matters dealt with in this part of the article are covered in accordance with IFRS 9. These matters are also dealt with in IAS 39, but IFRS 9 replaces this guidance. IFRS 9 will not be compulsory until 2015 (early adoption is permitted), and the IAS 39 guidance remains in force until then. IAS 39 has not yet been

replaced in respect of several other accounting matters but these are beyond the scope of the P1 syllabus, and therefore this article.

## **Recognition and derecognition**

### Initial recognition of a financial asset or liability

An entity shall recognise a financial asset or a financial liability on its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument.

### Derecognition of a financial asset

A financial asset is derecognised when the entity is no longer entitled to control any benefits accruing from it. This could occur due to the sale of an asset for example.

### Derecognition of a financial liability

An entity shall remove a financial liability (or a part of a financial liability) from its books when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expires. For example, when a liability is paid off, it is derecognised.

## **Classification**

### Classification of financial assets

There are two sub-classifications used for financial assets. These are:

1. Amortised cost
2. Fair value

The choice should be made on the basis of (1) the entity's business model for managing the asset and (2) the contractual cash flow characteristics of the asset.

In general, if the contractual cash flows are solely payments of principal and interest on the principal amount outstanding AND the asset is being held with the intention of drawing the contracted cash flows, then the amortised cost classification is appropriate. Otherwise fair value should be used.

Interest is defined as compensation for the time value of money.

By way of example, if the asset is held for trading purposes to make short term gains from any increase in its market value, it should be classified at fair value.

### Classification of financial liabilities

Financial liabilities should generally be classified as "amortised cost". There are circumstances when the fair value classification should be used for financial liabilities, but these are beyond the scope of the P1 syllabus.

## **Measurement – initial and subsequent**

### Initial measurement of financial assets and financial liabilities

When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value.

### Definition of fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. In the case of an asset or liability acquired on the date of initial recognition, fair value is usually assumed to be its cost.

### Subsequent measurement of financial assets and financial liabilities

Financial assets and liabilities are revalued at each reporting date in accordance with the classification method adopted.

- If classified as “amortised cost”, the effective interest rate method is applied in arriving at an updated valuation at each reporting date. See example 1 for an illustration of how this works.
- If classified as “fair value”, the asset is revalued to fair value at each reporting date. Gains and losses are normally taken to profit or loss but see the next paragraph for an important exception. Examples 2 and 3 will illustrate.

### Irrevocable election to take gains and losses to other comprehensive income

Equity investments (note, not all financial assets are allowed this exception – just equity investments) classified as fair value financial assets may have valuation gains and losses recognised through other comprehensive income (instead of profit or loss) if an irrevocable election to do so was made in writing at acquisition. Such gains or losses are **not** recycled to profit or loss on disposal of the equity instrument under IFRS 9 (IAS 39 did allow such recycling). Gains and losses on disposal are of course taken to profit or loss as always.

### Costs of acquisition

Direct costs of acquisition are included in the capitalised amount only in the case of a financial asset or financial liability **not** held at fair value through profit or loss (FVTPL). If the asset or liability is held at FVTPL the costs of acquisition are expensed.

Therefore in the case of financial assets or liabilities held under the amortised cost classification, costs of acquisition are treated as part of the capitalised value of the instrument. They would be added to the asset and deducted from the liability amount. Likewise, if a financial asset is the subject of the irrevocable election referred to above, costs of acquisition should be included with the purchase cost.

Summary:

<b>Category of financial asset or financial liability</b>	<b>Example of instruments</b>	<b>Accounting treatment: subsequent to acquisition</b>
Amortised cost	Bonds & other similar investments where cash flows consist of known payments of interest and principal, and the intention is to hold the instrument to maturity. Most financial liabilities.	Amortised cost – gains & losses are taken to profit / loss.
Fair value	All other financial assets. Some financial liabilities beyond the scope of the P1 syllabus.	Revalued to fair value at each reporting date. Gains and losses normally taken to profit or loss. <b>BUT</b> If an irrevocable election is made on initial recognition, unrealised gains and losses on investments in <u>equity instruments</u> may be recognised in OCI. These are NOT recycled on disposal.

		In exceptional cases, if insufficient information is available to determine fair value, cost may be deemed the best estimate of fair value.
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## IFRS 7: Financial Instruments - Disclosures

The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- the significance of financial instruments for the entity's financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.

### EXAMPLES:

#### Example 1: financial asset

Harry plc purchases a bond for €441,014 on 1 Jan 2012. It will be redeemed on 31 December 2015 for €600,000. Harry intends to hold the bond to maturity and it carries no interest coupon. The final payment of €600,000 consists entirely of compensation for principal advanced by Harry and accrued interest thereon. The effective rate of return is 8%.

**Required:** Discuss how this bond will be recognised on purchase, and subsequently accounted for over its life as an investment of Harry plc. Assume the reporting date is 31 December each year. Show appropriate journal entries.

#### Example 1: Solution

The bond will be classified as an amortised cost financial asset. This is because the payment due consists entirely of principal and interest, and Harry plc has the intention to hold the investment to collect the contractual cash flows. Therefore it is accounted for under the "amortised cost" method. This method allocates the effective interest income to the accounting periods the investment is held using the effective interest rate method. Accounting treatment and journal entries are as follows:

1 January 2012:

Initial recognition is at fair value. This is deemed to be the amount paid for the financial asset. If there were costs incurred on the purchase these would be capitalised also.

Dr Financial asset	€441,014	
Cr Cash		€441,014

31 December 2012:

Interest for the year is calculated at 8% on the balance outstanding for the year 2012. This is credited to income as a gain, and increases the carrying value of the financial asset. Amount =  $441,014 \times 8\% = 35,281$ . If the interest were paid, the debit would be to cash. If the interest were partially paid, the unpaid amount would increase the carrying value of the financial asset.

Dr Financial asset	€35,281	
Cr Profit or loss - Finance income		€35,281

31 December 2013:

Interest for year is again calculated at 8% of the amount outstanding. However, the amount outstanding is deemed to include the accrued but unpaid interest recognised in prior periods. Hence the interest income for 2013 is  $(441,014 + 35,281) \times 8\% = 38,104$ .

Dr Financial asset	€38,104	
Cr Profit or loss - Finance income		€38,104

31 December 2014:

The same principle applies to 2014 and 2015 as applied to 2013. Interest for year =  $(441,014 + 35,281 + 38,104) \times 8\% = 41,152$ .

Dr Financial asset	€41,152	
Cr Profit or loss - Finance income		€41,152

31 December 2015:

Interest for year =  $(441,014 + 35,281 + 38,104 + 41,152) \times 8\% = 44,444$

Dr Financial asset	€44,444	
Cr Profit or loss - Finance income		€44,444

31 December 2015:

The repayable amount is €600,000. As the carrying amount is slightly different due to rounding errors, the difference of €5 is taken to profit or loss at the date of disposal of the investment. The investment is derecognised as the entity no longer has an interest in the bond.

Dr Cash	€600,000	
Cr Financial asset (sum of entries to date)		€599,995
Cr Profit or loss - Finance income		€5

### Example 2: financial asset

Louise plc purchased 10,000 shares in another company during 2011 as a long term investment for a cost of €4.50 per share, incurring transaction costs of €1,450. She made an irrevocable election immediately after purchase to take all remeasurement gains and losses through "other comprehensive income" as allowed by IFRS 9. The market value of the shares at 31 December 2011 was €5.04 per share. It would cost €1,500 in transaction costs to sell the shares at that date. In the event, due to liquidity problems, Louise plc had to sell the shares in 2012 for €5.45 per share, incurring transaction costs of €1,510 on the deal.

**Required:** Discuss the accounting treatment of the financial asset in 2011 and 2012. Assume the financial year ends on 31 December each year. Show appropriate journal entries.

### Example 2: Solution

The shares are classified as a fair value financial asset. This is because they do not meet the criteria for classification under amortised cost. As the election was made under IFRS 9 to take gains and losses on remeasurement to other comprehensive income, they are not accounted for as fair value through profit or loss. This means the transaction costs are included in the amount capitalised. Therefore they are recognised initially at fair value plus transaction costs [€46,450 (10,000 shares \* €4.50) + €1,450].

Initial recognition during 2011:

Dr Financial assets	€46,450	
Cr Cash		€46,450

At each period end, the investment is revalued to fair value. This is the quoted market price at the end of the reporting period. In this case this is €5.04 per share giving a total value of €50,400. No allowance is made for transaction costs, as no transaction has occurred. This represents a gain of €3,950 (50,400 – 46,450). Any gain or loss is recognised in the statement of comprehensive income through “other comprehensive income” in accordance with the election made by Louise.

31 December 2011 (remeasurement):

Dr Financial assets (50,400-46,450)	€3,950	
Cr Other comprehensive income		€3,950

On disposal, the asset is derecognised, and any difference between the carrying value and the net proceeds is recognised within profit or loss. The net disposal proceeds are €5.45 per share less transaction costs of €1,510 [(10,000 \* 5.45) – 1,510] or €52,990. The carrying value is €50,400, leading to a gain on disposal of €2,590.

Disposal during 2012:

Dr Cash	€52,990	
Cr Financial assets		€50,400
Cr Profit or loss – gain on disposal of financial assets		€2,590

### Example 3: financial asset

Take the scenario in example 2 above and assume that Louise plc did not make the election to take gains and losses to “other comprehensive income”.

**Required:** Discuss the accounting treatment of the financial asset in 2011 and 2012. Assume the financial year ends on 31 December each year. Show appropriate journal entries.

### Example 3: Solution

The shares are again classified as a fair value financial asset. This is again because they do not meet the criteria for classification as amortised cost. However, as the election was not made under IFRS 9 to take gains and losses on remeasurement to other comprehensive income, these assets are accounted for at fair value through profit or loss. Therefore transaction costs are NOT included in the amount capitalised on initial purchase. This means they are recognised initially at fair value, and transaction costs are expensed.

Initial recognition during 2011:

Dr Financial assets	€45,000	
Dr Profit or loss (expenses on purchase)	€1,450	
Cr Cash		€46,450

At each period end, the investment is revalued to fair value. This is the quoted market price at the end of the reporting period. In this case this is €5.04 per share giving a total value of €50,400. No allowance is made for transaction costs, as no transaction has occurred. This represents a gain of €5,400 (50,400 – 45,000). Any gain or loss is recognised in the statement of comprehensive income through profit or loss.

31 December 2011 (remeasurement):

Dr Financial assets	€5,400	
Cr Profit or loss		€5,400

On disposal, the asset is derecognised, and any difference between the carrying value and the net proceeds is recognised within profit or loss. The net disposal proceeds are €5.45 per share less transaction costs of €1,510 [(10,000 \* 5.45) – 1,510] or €52,990. The carrying value is €50,400, leading to a gain on disposal of €2,590. There is no difference between example 2 and 3 on disposal.

Disposal during 2012:

Dr Cash	€52,990	
Cr Financial assets		€50,400
Cr Profit or loss – gain on disposal of financial assets		€2,590