FRS 102 Financial Instruments
Factsheet 4

by Robert Kirk

Robert Kirk reviews Factsheet 4 on how to account for financial instruments.

In December 2013, the Financial Reporting Council (FRC) published 16 Staff Education Notes (SENs) to aid users implement FRS 102. The SENs were not part of FRS 102. They were simply aimed at helping preparers apply certain requirements of FRS 102 but they were not to be relied upon as definitive statements on how to apply the standard.

In December 2018, the FRC decided to publish further guidance in the form of Factsheets which should be treated in the same vein as the SENs. One of these (Number 4) is on the topic of how to account for financial instruments which is much broader in scope than two of the SENs i.e. SEN 16 Financing Transactions and SEN 2 Debt instruments – amortised cost. This short article will look at some of the issues raised in the guidance.

Classification of financial instruments

The factsheet lists cash and investments in most ordinary and some preference shares as 'basic' as well as debt instruments as long as the criteria in paragraph 11.9 of FRS 102 are met. However, there have been issues with this restrictive definition and, as a result, a number of instruments have been classified as 'other' although their substance was 'basic'. To solve this an additional paragraph, 11.9A, has been introduced into FRS 102 which the Factsheet emphasizes introduces an additional principles-based description which should be applied if an instrument fails the detailed 11.9 criteria to identify if it could be classified as 'basic'.

Directors' loans can meet the paragraph 11.9 (a) criteria as the contractual return to the holder is a fixed amount of €nil i.e. the interest free element is irrelevant to its classification. However, the other criteria in paragraph 11.9 may be failed and thus there must still be reasonable compensation for the time value of money, credit risk and other basic lending risks which is unlikely to be the case for an interest free loan.

Measurement of basic financial instruments

Normally basic instruments are recorded initially at transaction price as adjusted for transaction costs. There is one exception – financing transactions - as follows:

Financing transactions

Where goods or services are sold on credit there are two components to the transaction – a sale and a financing arrangement. These must be accounted for separately as follows:

Facts: ABC Ltd sells a motor vehicle to a customer for €15,000 on 1st January 2019, payment due in two years' time. Normally if sold for immediate cash the sale would be €13,500			
Solution			
Dr Trade receivables	€13,500		1.1.19
Cr Sales		€13,500	
Dr Trade receivables	€1,500		Use amortised cost method to spread income over 2 years
Cr Interest income		€1,500	

The Factsheet also gives an example of how the customer should apply the transaction under Section 17 Property, plant and equipment by recording the motor vehicle initially at €13,500 with a subsequent interest expense being recorded using the same amortised cost methodology as the seller. That provides symmetry of accounting treatment between the two parties to the transaction.

However, there are two exceptions to that general rule:

1. Directors loans – small entities only under Section 1A FRS 102 Loans to the entity not at market rate from a person who is a member of a director's group of close family and the group includes at least one shareholder in the entity – can measure at transaction price.

2. Public benefit entity concessionary loans – can measure at the amount paid or received.

There are a number of examples in the Appendix to Factsheet 4 which are identical to those provided by SEN 16 covering interest free loans between a parent and a subsidiary, between fellow subsidiaries and between entities owned by the same person. It also includes fixed term interest free loans between entities and their directors and an example of how to treat subsequent measurement of interest free loans.

The accounting treatment of a fixed term interest free loan between entities owned by the same person is similar in that the lending entity should record the difference as a distribution and the borrowing entity as a capital contribution. Another similar example provided in the Factsheet is that of a fixed term interest free loan between an entity and its directors. If the director lends money the difference is treated as a capital contribution in the entity's financial statements and if the entity lends money to the director it is treated as a distribution.

Basic financial instruments – subsequent measurement

These should be measured at amortised cost using the effective rate method. This ensures that the interest and transaction costs are allocated at a constant rate on the carrying amount over the life of the instrument.

However short-term payables and receivables due within one year, which are not discounted, are measured at their invoiced amount until paid or received. In addition, as long as a market rate of interest is charged and there are no transaction costs then the effective rate is equal to the market rate of interest.

Subsequent measurement of interest free loans

Facts

On 1st January a subsidiary obtains a two-year interest free loan of €50,000 from its parent. Assume market rate of interest is 5.4%.

Solution:

Subsidiary's books			
	Debit €	Credit €	Notes
Bank	50,000		
Loan		45,000	Initial
Capital Expenditure		5,000	
Interest Expense – Yr 1	2,450		
Interest Expense – Yr 2	2,550		Spread using effective interest rate over 2 years
Loan		5,000	
Loan	50,000		
Bank		50,000	Repayment

Parent's books			
	Debit €	Credit €	Notes
Loan Receivable	45,000		
Distribution	5,000		Initial
Bank		50,000	
Loan Receivable	5,000		
Interest Income – Yr 1		2,450	Spread using effective interest rate over 2 years
Interest Income – Yr 2		2,550	
Bank	50,000		
Loan Receivable		50,000	Repayment

Impairment

Each reporting entity must assess at the end of each reporting period whether or not an impairment has occurred which needs to be written off against the financial asset. FRS 102 still uses the incurred loss model so there must be objective evidence of impairment. Possible future events is not a basis for recognising an impairment. Significant financial assets should be assessed individually but others can be grouped based on similar risk characteristics.

Derecognition

A financial asset should only be derecognised when it is settled or the contractual rights to its associated cash flows have expired. In addition, if a financial asset is transferred to another party i.e. factored, then it is only derecognised if the entity believes that substantially all the risks and rewards of ownership has been transferred. Otherwise the asset should be retained and any cash received treated as a loan.

Similarly, a financial liability is only derecognised if it is discharged, cancelled or the rights to future cash flows have expired. However, where an existing loan has been renegotiated with the result that it is substantially modified then the original liability is said to be extinguished and a new loan set up in its place. This will normally result in a gain/loss being created on the difference and this should be reported in profit and loss.

Disclosure

The factsheet points out that there are substantial reductions in disclosure for both small entities under Section 1A as well as to subsidiaries and parent companies of groups reporting their consolidated accounts under FRS 102.

It then goes on to briefly outline the key disclosures under the standard including the significant accounting policies adopted for financial instruments, their measurement bases as well as the carrying amounts measured at fair value through profit and loss. It also mentions the key performance items such as interest income and expenses and changes in fair value.

However, it specifically highlights paragraph 11.42:

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

It emphasizes that this is a principles-based disclosure requirement and provides some examples of possible disclosures for a debt instrument including – the interest rate, maturity, repayment schedule and any restrictions. It points out, however, that entities will have to consider carefully what information would be required by users.

Financial instruments at fair value through profit and loss

Company law sets out which financial instruments can be measured at fair value together with disclosures. In the Republic of Ireland (ROI) all financial instruments can be measured at fair value if permitted by IFRS but this requires additional disclosure which has been incorporated into Section 11 of FRS 102.

Financial institutions and retirement benefit plans

Both of these types of entity are required to provide additional disclosure and this is contained in Section 34 Specialised activities of the standard.

Other (non-basic) instrument issues

All financial instruments within the scope of Section 12 of FRS 102 should subsequently measure them at fair value with gains and losses being reported in profit and loss.

However, there are a few exceptions particularly in certain hedge accounting situations and if fair value is not permitted by company law. However, this is not expected to occur very often.

Typical derivatives such as interest rate swaps and foreign exchange contracts will have to be measured at fair value each year with changes reported in profit and loss. The only exception to that would be if an entity adopted hedge accounting.

Summary

Accountants who are involved in the preparation of financial statements under FRS 102 will find the content, presentation and layout of the Factsheet on financial instruments to be a very useful supplementary tool. However, it will still be essential to read the actual standard itself to ensure full compliance with FRS 102

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