IFRS Link

January 2005 Issue Number 5

In this the first edition of 2005 we look at two of the more complex international financial reporting standards namely those dealing with accounting for financial instruments. These standards are:

IAS 32 - Financial instruments: disclosure and presentation

IAS 39 - Financial instruments: recognition and measurement

Both standards were substantially re-written as part of the International Accounting Standards Boards improvements project with the revised standards applying for periods beginning on or after 1st January 2005.

What is a financial instrument?

A financial instrument is any contract which results in a financial asset in one entity and a financial liability in another. Therefore, it is not just sophisticated instruments that are included within the requirements but also those used by many companies to manage their day to day finances. Financial assets include cash, equity instruments in another entity, as well as a contractual right to receive cash or another financial asset. A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset. Therefore, the definition encompasses everything from complex instruments through to trade debtors and creditors.

Classifying financial assets

IAS 39 requires that all financial assets be classified into one of the following four categories:

- At fair value through profit and loss (FVTPL).
- Held to maturity.
- Loans and receivables.
- Available for sale.

The classification is important as it dictates how the financial asset is measured.

Any financial asset can be designated as FVTPL when it is first recognised, although the IASB are seeking to restrict this option through a proposed amendment to IAS 39. In addition, any financial asset which is acquired for trading will be classed as FVTPL.

Held to maturity instruments are those that have fixed or determinable payments and fixed maturity and they are measured at cost. Where a held to maturity asset is disposed of or re-classified before its maturity date, all of the entity's held to maturity assets will need to be reclassified as available for sale. In addition, the entity will be prohibited from classifying any investments as held to maturity for the next two financial years.

Loans and receivables are non-derivitave financial assets with fixed or determinable payments and they are also measured at cost.

Any financial asset that is not classified in any of the above categories is an available for sale financial asset.

Financial liabilities and equity

Financial instruments are required to be classified as either financial liabilities or equity. The main principle is that where the issuer does not have an unconditional right to avoid the obligation to deliver cash, and where the contract does not in substance evidence a residual interest in the net assets after deducting all liabilities, it is not an equity interest and must be recorded as a liability. Preference shares may be required to be classified as either equity or liabilities dependent on their exact terms.

Compound financial instruments (for example many types of convertible debt) have both equity and liability elements. Such instruments are required to be 'split accounted' by calculating the fair value of the instrument as a whole and then deducting from this the fair value of the liability element.

The residual amount is the equity component and is included within equity in the financial statements.

Financial liabilities are classified into one of two categories:

- Financial liabilities at fair value through profit and loss.
- Other financial liabilities, which are measured at amortised cost.

Financial liabilities at fair value through profit and loss are either those that are held for trading or those which have been designated as such on initial recognition.

The classification of the financial instrument also determines the accounting treatment of the associated finance costs and any gains and losses. Amounts to be included as finance costs in the profit and loss account include interest, dividend payments on preference shares classified as debt and gains and losses on redemption and refinancing. Dividends on shares classified as equity are accounted for within equity as are directly attributable costs of issuing or repurchasing an entity's own shares.

Derivatives and embedded derivatives

A derivative is defined as being a financial instrument that has all of the following characteristics:

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange contract, index of prices or rates, credit rating or credit index, or other variable (this is sometimes referred to as the 'underlying').
- It requires no initial investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response.
- It is settled at a future date.

Whilst the concept of derivatives may be reasonably familiar, IAS 39 also introduces the term embedded derivative. Whilst the definition is reasonably simple application is somewhat more complex. Entities are also required to consider whether there are embedded derivatives in contracts other than financial instruments. They could exist in any contract, for example a lease, an insurance contract or a purchase or sale contract. In certain circumstances embedded derivatives are required to be stripped from the host contract and separately accounted.

In simple terms, an embedded derivative results in modification of the cash flows that would otherwise arise under a contract by reference to a specified interest rate, financial instrument price, commodity price, foreign exchange rate or other variable.

An embedded derivative is separated from the host contract when the following conditions are fulfilled:

- The economic characteristics and risks of the embedded derivative are not closely related to the economic risks and characteristics of the host.
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- The hybrid instrument is not measured at fair value with changes in fair value recognised in profit and loss.

Measuring financial instruments

IAS 39 requires a combination of fair value and cost measurement dependent on the classification of the financial instrument.

Financial assets are required to be measured at fair value unless they fall into specific categories - for example held to maturity. Financial liabilities are more usually accounted for at cost, although there are exceptions where fair values are applied, in particular derivatives.

All financial assets and liabilities are originally measured at fair value - namely the amount an asset could be acquired for or a liability settled, between willing and knowledgeable third parties.

Subsequent measurement will be determined by the accounts classification. Financial assets at fair value through profit and loss are recorded at fair value with changes in value being reported in the income statement. Held to maturity assets are measured at amortised cost, as are loans and receivables. Available for sale assets are measured at fair value with changes in value being recorded in reserves.

Fair value is determined as follows:

- For an asset - the amount that would be realised from the disposal of the asset, rather than the amount it would cost to acquire it.
- For a liability - the amount it would cost to discharge the liability, rather than the amount that would be received in return for taking it on.

Recognition and derecognition

A financial asset or financial liability should only be recognised when the entity becomes a party to the contractual provisions of the financial instrument.

A financial asset is derecognised when, and only when, either the contractual rights to the asset's cash flows expire, or the asset is transferred and the transfer qualifies for derecognition. To determine this it is necessary to apply a combination of tests based both on risks and rewards and control. The risks and rewards tests look at whether, having transferred the asset, the entity continues to be exposed to the risks of ownership and/or continues to enjoy benefits from the asset. The control tests seek to look at whether the entity can direct how the benefits of the asset can be realised. IAS 39 contains a decision tree to assist with the application of the derecognition hierarchy.

A financial liability is derecognised when, and only when, it is extinguished - i.e. when it is discharged, cancelled or expires.

Hedge accounting

The objective of hedge accounting is to ensure that the gain or loss on the hedging instrument is recognised in the income and expenditure account in the same period as the gains or losses arising on the item being hedged.

Whilst hedge accounting is voluntary, IAS 39 only allows it to be used in specific circumstances. Where an entity wants to apply hedge accounting, it must formally document in writing its intention to apply hedge accounting prospectively. It is not possible to apply hedge accounting retrospectively. The documentation must identify the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and specify how 'effectiveness' will be assessed and ineffectiveness measured.

IAS 39 recognises three types of hedge:

- Fair value hedge - hedge of the exposure to changes in fair value of a recognised asset or liability, an unrecognised firm commitment, or an identified portion of such an asset, liability or commitment that is attributable to a particular risk that could affect profit or loss.
- Cash flow hedge - hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and which could affect profit and loss.
- Hedge of net investment in a foreign operation - hedge of the foreign currency exposure to changes in the reporting entity's share in the net assets of that foreign operation.

IAS 39 does not prescribe a specific method for assessing effectiveness, but it does require the entity to define at inception the method it will use. A hedge is regarded as highly effective only if both of the following conditions are met:

- At inception and in subsequent periods the hedge is expected to be highly effective in achieving offsetting of changes in fair value or cash flows attributable to the hedged risk during the period it is designated as a hedge.
- The actual results of the hedge are within a range of 80-125 percent.

When actual results fall within the range, but are not 100% this means that the hedge is partly ineffective and the ineffectiveness needs to be recognised in the accounts.

In a fair value hedge, because all movements are recognised in the profit and loss account, the ineffective portion is automatically recorded in income. In a cash flow hedge the amount that is considered to be effective, and therefore is deferred in equity, is the lesser of:

- The cumulative gain or loss on the hedging instrument from inception of the hedge, and
- The cumulative change in fair value of the expected future cash flows on the hedged item from inception of the hedge.

At the inception of the hedge there needs to be formal designation and documentation of both the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. The documentation is required to include the following:

- Identification of the hedging instrument.
- The hedged item or transaction.
- The nature of the risk being hedged.
- How effectiveness will be assessed.

The documentation requirements fall into two categories

- Specific documentation for each hedge entered into.
- Overall risk management objectives and strategies.

Presentation and disclosure

IAS 32 contains disclosure requirements which are both narrative and numerical. The format and location of these disclosure requirements is not however prescribed within the standard.

The disclosure requirements cover the following areas:

- Risk management policies and hedging activities.
- Terms and conditions of financial instruments and the accounting policies adopted for them.
- Interest rate risk.
- Credit risk.
- Fair value.
- The effect on both the income statement and equity.
- Any defaults or breaches.
- Areas of judgement and accounting choice.

Concessions for first time adopters

First time adopters before 1st January 2006 are not required to present their comparative information in compliance with IAS 32 and IAS 39.

In addition, to the extent that the liability component of a compound financial instrument is no longer outstanding at the time of first time adoption, there is no requirement for full retrospective application of IAS 32.

For further details about the articles contained in this publication, please contact Yvonne Lang at:

Smith & Williamson/Nexia Audit Ltd, No.1 Riding House Street, London, W1A 3AS, UK.
tel: + 44 (0) 20 7637 5377, fax: + 44 (0) 20 7631 0741, email: yvonne.lang@smith.williamson.co.uk