Accounting (Basics) – Lecture 7

Basic and other financial instruments

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Basic financial instruments vs. other financial instruments

- A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
- An amortized cost model is required for all basic financial instruments except for investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably.
- Basic financial instruments are:
  a) cash
  b) a debt instrument
  c) a commitment to receive a loan that cannot be settled net in cash, and when the commitment is executed
  d) an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.

Basic financial instruments vs. other financial instruments

- A debt instrument that satisfies all of the conditions in (a)–(d) below shall be accounted for as basic financial instrument. Conditions for financial instrument to be accounted for as basic one:
  a) returns to the holder are
     i. a fixed amount;
     ii. a fixed rate of return over the life of the instrument;
     iii. a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR); or
     iv. some combination of such fixed rate and variable rates (e.g. LIBOR plus 200 basis points), provided that both the fixed and variable rates are positive. For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.

Basic financial instruments vs. other financial instruments

b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

c) Contractual provisions that permit the issuer (the debtor) to prepay a debt instrument or permit the holder (the creditor) to put it back to the issuer before maturity are not contingent on future events.

d) There are no conditional returns or repayment provisions except for the variable rate return described in (a) and prepayment provisions described in (c).

- Other financial instruments are:

a) asset-backed securities, such as collateralized mortgage obligations, repurchase agreements and securitized packages of receivables.

Basic financial instruments vs. other financial instruments

b) options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument.

c) financial instruments that qualify and are designated as hedging instruments

d) commitments to make a loan to another entity.

e) commitments to receive a loan if the commitment can be net settled in cash.

- Other financial instruments do not include:

a) basic financial instruments.

b) interests in subsidiaries, associates and joint ventures.

c) employers' rights and obligations under employee benefit plans.

d) rights under insurance contracts unless the insurance contract could result in a loss to either party as a result of contractual

Basic financial instruments vs. other financial instruments

terms that are unrelated to changes in the insured risk, changes in foreign exchange rates or a default by one of the counterparties.

e) financial instruments that meet the definition of an entity’s own equity

f) leases unless the lease could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to changes in the price of the leased asset, changes in foreign exchange rates or a default by one of the counterparties.

g) contracts for contingent consideration in a business combination. This exemption applies only to the acquirer.

Initial recognition of basic and other financial instruments

- An entity shall recognize both basic and other financial instruments only when the entity becomes a party to the contractual provisions of the instrument.

Initial and subsequent measurement of basic financial instruments

- When a financial asset or financial liability is recognized initially, an entity shall measure it at the transaction price (including transaction costs except in the initial measurement of financial assets and liabilities that are measured at fair value through profit or loss) unless the arrangement constitutes, in effect, a financing transaction. A financing transaction may take place in connection with the sale of goods or services, for example, if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate. If the arrangement constitutes a financing transaction, the entity shall measure the financial asset or financial liability at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

Initial and subsequent measurement of basic financial instruments

- Subsequently, at the end of each reporting period, an entity shall measure financial instruments as follows:
  a) Debt instruments shall be measured at amortized cost using the effective interest method. Debt instruments that are classified as current assets or current liabilities shall be measured at the undiscounted amount of the cash or other consideration expected to be paid or received (i.e. net of impairment) unless the arrangement constitutes, in effect, a financing transaction. If arrangement constitutes a financing transaction, the entity shall measure the debt instrument at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.
  b) Commitments to receive a loan shall be measured at cost less impairment.

Initial and subsequent measurement of basic financial instruments

c) Investments in non-convertible preference shares and non-puttable ordinary or preference shares shall be measured as follows:

   i. if the shares are publicly traded or their fair value can otherwise be measured reliably, the investment shall be measured at fair value with changes in fair value recognized in profit or loss.

   ii. all other such investments shall be measured at cost less impairment.

   iii. the amortized cost of a financial asset or financial liability at each reporting date is the net of the following amounts:

d) the amount at which the financial asset or financial liability is measured at initial recognition,

e) minus any repayments of the principal,

Initial and subsequent measurement of basic financial instruments

f) plus or minus the cumulative amortization using the effective interest method of any difference between the amount at initial recognition and the maturity amount,

g) minus, in the case of a financial asset, any reduction for impairment or uncollectibility.

- Basic financial assets and financial liabilities that have no stated interest rate and are classified as current assets or current liabilities are initially measured at an undiscounted amount. Therefore, (c) above does not apply to them.
- The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective

Initial and subsequent measurement of basic financial instruments

interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the carrying amount of the financial asset or financial liability. The effective interest rate is determined on the basis of the carrying amount of the financial asset or liability at initial recognition. Under the effective interest method:

a) the amortized cost of a financial asset (liability) is the present value of future cash receipts (payments) discounted at the effective interest rate, and
b) the interest expense (income) in a period equals the carrying amount of the financial liability (asset) at the beginning of a period multiplied by the effective interest rate for the period.

- When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial

Initial and subsequent measurement of basic financial instruments

instrument and known credit losses that have been incurred, but it shall not consider possible future credit losses not yet incurred.

- When calculating the effective interest rate, an entity shall amortize any related fees, finance charges paid or received, transaction costs and other premiums or discounts over the expected life of the instrument.
- For variable rate financial assets and variable rate financial liabilities, periodic re-estimation of cash flows to reflect changes in market rates of interest alters the effective interest rate.

Initial and subsequent measurement of basic financial instruments

- If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability to reflect actual and revised estimated cash flows. The entity shall recalculate the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The entity shall recognize the adjustment as income or expense in profit or loss at the date of the revision.

Initial and subsequent measurement of other financial instruments

- When a other financial asset or financial liability is recognized initially, an entity shall measure it at its fair value, which is normally the transaction price.
- Subsequently, at the end of each reporting period an entity shall measure all other financial instruments at fair value and recognize changes in fair value in profit or loss, except as follows: equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.
- If a reliable measure of fair value is no longer available for an equity instrument that is not publicly traded but is measured at fair value through profit or loss, its fair value at the last date the instrument

Initial and subsequent measurement of other financial instruments

was reliably measurable is treated as the cost of the instrument. The entity shall measure the instrument at this cost amount less impairment until a reliable measure of fair value becomes available.

- An entity shall not include transaction costs in the initial measurement of financial assets and liabilities that will be measured subsequently at fair value through profit or loss. If payment for an asset is deferred or is financed at a rate of interest that is not a market rate, the entity shall initially measure the asset at the present value of the future payments discounted at a market rate of interest.

Impairment of basic and other financial instruments

- At the end of each reporting period, an entity shall assess whether there is objective evidence of impairment of any financial assets that are measured at cost or amortized cost. If there is objective evidence of impairment, the entity shall recognize an impairment loss in profit or loss immediately.
- Objective evidence that a financial asset or group of assets is impaired includes observable data that come to the attention of the holder of the asset about the following loss events:
  a) significant financial difficulty of the issuer or obligor.
  b) a breach of contract
  c) the creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider.
  d) it has become probable that the debtor will enter bankruptcy or other financial reorganization.

Impairment of basic and other financial instruments

e) observable data indicating that there has been a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions.

- An entity shall assess the following financial assets individually for impairment:
  a) all equity instruments regardless of significance, and
  b) other financial assets that are individually significant.
- An entity shall assess other financial assets for impairment either individually or grouped on the basis of similar credit risk characteristics.
- An entity shall measure an impairment loss on the following instruments measured at cost or amortized cost as follows:

Impairment of basic and other financial instruments

a) for an instrument measured at amortized cost – the impairment loss is the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the asset's original effective interest rate.

b) for an instrument measured at cost less impairment – the impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which might be zero) that the entity would receive for the asset if it were to be sold at the reporting date.

- If in a subsequent period the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the entity shall reverse

Impairment of basic and other financial instruments

the previously recognized impairment loss either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset (net of any allowance account) that exceeds what the carrying amount would have been had the impairment not previously been recognized. The entity shall recognize the amount of the reversal in profit or loss immediately.

- An investment in ordinary shares or preference shares are required to be measured at fair value if the fair value of the shares can be measured reliably. An entity shall use the following hierarchy to estimate the fair value of the shares:
  a) The best evidence of fair value is a quoted price (i.e. a bid price) for an identical asset in an active market.
  b) When quoted prices are unavailable, the price of a recent transaction for an identical asset provides evidence of fair value as long as there has not been a significant change in economic circumstances or a significant lapse of time since the transaction took place. If the entity can demonstrate that

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the last transaction price is not a good estimate of fair value (e.g. because it reflects the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted.

c) If the market for the asset is not active and recent transactions of an identical asset on their own are not a good estimate of fair value, an entity estimates the fair value by using a valuation technique. The objective of using a valuation technique is to estimate what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations.

- Valuation techniques include using recent arm's length market transactions for an identical asset between knowledgeable, willing parties, if available, reference to the current fair value of another asset that is substantially the same as the asset being measured, discounted cash flow analysis and option pricing models.

Impairment of basic and other financial instruments

- If a reliable measure of fair value is no longer available for an asset measured at fair value (e.g. an equity instrument measured at fair value through profit or loss), its carrying amount at the last date the asset was reliably measurable becomes its new cost. The entity shall measure the asset at this cost amount less impairment until a reliable measure of fair value becomes available.

Derecognition of basic and other financial instruments

- An entity shall derecognize a financial asset only when:
  a) the contractual rights to the cash flows from the financial asset expire or are settled, or
  b) the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset, or
  c) the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this case, the entity shall derecognize the asset, and recognize separately any rights and obligations retained or created in the transfer.
- The carrying amount of the transferred asset shall be allocated between the rights or obligations retained and those transferred on the basis of their relative fair values at the transfer date.

Derecognition of basic and other financial instruments

- If a transfer does not result in derecognition because the entity has retained significant risks and rewards of ownership of the transferred asset, the entity shall continue to recognize the transferred asset in its entirety and shall recognize a financial liability for the consideration received.
- If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted.

Derecognition of basic and other financial instruments

- An entity shall derecognize a financial liability (or a part of a financial liability) only when it is extinguished, i.e. when the obligation specified in the contract is discharged, is cancelled or expires.
- If an existing borrower and lender exchange financial instruments with substantially different terms, the entities shall account for the transaction as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, an entity shall account for a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) as an extinguishment of the original financial liability and the recognition of a new financial liability.
- The entity shall recognize in profit or loss any difference between the carrying amount of the financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed.

Hedge accounting for other financial instruments

- If specified criteria are met, an entity may designate a hedging relationship between a hedging instrument and a hedged item in such a way as to qualify for hedge accounting. Hedge accounting permits the gain or loss on the hedging instrument and on the hedged item to be recognized in profit or loss at the same time.
- To qualify for hedge accounting, an entity shall comply with all of the following conditions:
  a) the entity designates and documents the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified and the risk in the hedged item is the risk being hedged with the hedging instrument.
  b) the hedged risk is one of the risks specified in paragraph below.
  c) the hedging instrument is as specified in paragraph below.

Hedge accounting for other financial instruments

the entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk. The effectiveness of a hedge is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

- Hedge accounting is permitted only for the following risks:
  a) interest rate risk of a debt instrument measured at amortized cost.
  b) foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction.
  c) price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity.
  d) foreign exchange risk in a net investment in a foreign operation.

Hedge accounting for other financial instruments

- Hedge accounting is permitted only if the hedging instrument has all of following terms and conditions:
  a) it is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract that is expected to be highly effective in offsetting a hedged risk.
  b) it involves a party external to the reporting entity.
  c) its notional amount is equal to the designated amount of the principal or notional amount of the hedged item.
  d) it has a specified maturity date not later than
     i. the maturity of the financial instrument being hedged,
     ii. the expected settlement of the commodity purchase or sale commitment, or
     iii. the occurrence of the highly probable forecast foreign currency or commodity transaction being hedged.
  e) it has no prepayment, early termination or extension features.

Disclosures for <u>basic</u> financial instruments

- An entity shall disclose, in the summary of significant accounting policies, the measurement basis used for financial instruments and the other accounting policies used for financial instruments that are relevant to an understanding of the financial statements.
- <u>The disclosures below make reference to disclosures for financial liabilities measured at fair value through profit or loss. Entities that have only basic financial instruments will not have any financial liabilities measured at fair value through profit or loss and hence will not need to provide such disclosures. Thus if references to financial liabilities measured at fair value through profit or loss are made, they are valid only for entities holding other financial instruments.</u>
- An entity shall disclose the carrying amounts of each of the following categories of financial assets and financial liabilities at the reporting date, in total, either in the statement of financial position or in the notes:

Disclosures for <u>basic</u> financial instruments

a) financial assets measured at fair value through profit or loss
b) financial assets that are debt instruments measured at amortized cost
c) financial assets that are equity instruments measured at cost less impairment
d) financial liabilities measured at fair value through profit or loss
e) financial liabilities measured at amortized cost
f) loan commitments measured at cost less impairment

- 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.

Disclosures for basic financial instruments

- For all financial assets measured at fair value, the entity shall disclose the basis for determining fair value, e.g. quoted market price in an active market or a valuation technique. When a valuation technique is used, the entity shall disclose the assumptions applied in determining fair value for each class of financial assets. If a reliable measure of fair value is no longer available for an equity instrument measured at fair value through profit or loss, the entity shall disclose that fact.
- When an entity has pledged financial assets as collateral for liabilities or contingent liabilities, it shall disclose the following:
  a) the carrying amount of the financial assets pledged as collateral.
  b) the terms and conditions relating to its pledge.
- An entity shall disclose the following items of income, expense, gains or losses:

Disclosures for basic financial instruments

a) income, expense, gains or losses, including changes in fair value, recognized on:
   i. financial assets measured at fair value through profit or loss.
   ii. financial assets measured at amortized cost.
   iii. financial liabilities measured at fair value through profit or loss.
   iv. financial liabilities measured at amortized cost.

b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not measured at fair value through profit or loss.

c) the amount of any impairment loss for each class of financial asset.

Disclosures for other financial instruments and hedge accounting

- An entity applying holding other financial instruments shall make all of the disclosures required for basic financial instruments and, in addition, if such entity also uses hedge accounting, it shall make the following additional disclosures:
  a) a description of the hedge.
  b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date.
  c) the nature of the risks being hedged, including a description of the hedged item.