chapter 8

# *Financial instruments*

overview

In this chapter we deal with capital instruments and the broader category of financial instruments, including derivatives, as well as hedge accounting. This is currently an area of much flux and uncertainty. Standard setters are only now coming to grips with the vexed subjects of derivatives and hedge accounting but perhaps the major cause of uncertainty is the impact of the convergence programme. The relevant International Standards, IAS 32 and 39, are still evolving while the UK standards are also being reviewed. The relevant UK Exposure Draft, FRED 30, is itself tentative in some places in referring to the need to await the completion of developments in the international standard-setting arena while some of its proposed changes depend on changes being made to UK company law.

The UK statements covered in this chapter are:

- FRS 4 *Capital Instruments* (1993)
- FRED 23 *Financial Instruments: Hedge Accounting* (2002)
- FRS 13 *Derivatives and other Financial Instruments: Disclosure* (1998)
- FRED 30 *Financial Instruments: Disclosure and Presentation and Financial Instruments: Recognition and Measurement* (2002)

The international standards to which we refer are:

- IAS 32 *Financial Instruments: Disclosure and Presentation* (revised 1998)
- IAS 39 *Financial Instruments: Recognition and Measurement* (revised 2000)

Both were in the process of revision as at January 2003.

## Introduction

A financial instrument can involve very simple things like cash, or something far more complicated, such as a derivative. At this stage it might be useful to introduce the definition of a financial instrument as set out in FRED 30 *Financial Instruments: Disclosure and Presentation*,[1] which is itself derived from IAS 32.

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

**A *financial asset* is any asset that is:**

**a) Cash;**
**b) A contractual right to receive cash or another financial asset from another entity;**

[1] FRED 30, Para. 5, p. 32.

c) A contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or
d) An equity instrument of another entity.

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

a) To deliver cash or another financial asset to another entity; or
b) To exchange financial instruments with another entity under conditions that are potentially unfavourable.

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

This is not an easy definition to understand and one always knows that there are problems when, as is the case with financial assets, the definition of a term includes the term itself. It is perhaps helpful to realise that the definition excludes physical assets and the obligations to provide services in the future. We will in this chapter concentrate on financial liabilities but will also need to touch on financial assets, especially in relation to derivatives and hedging transactions.

The present position with respect to accounting for financial instruments can best be described as 'messy'. The situation as this book went to press was that the ASB had issued FRED 30 as the forerunner of two possible standards, *Financial Instruments: Disclosure and Presentation and Financial Instruments: Measurement*. The messiness of the present position is that the proposed standards are based on proposed amended versions of two International Standards, IAS 32 *Financial Instruments: Disclosure and Presentation*, and IAS 39 *Financial Instruments: Recognition and Measurement*. Also, the implementation of some of the changes proposed in FRED 30 would require changes in UK company law. The proposed issue of the two new UK standards would lead to the withdrawal of two existing standards, FRS 4 *Capital Instruments* and FRS 13 *Derivatives and other Financial Instruments: Disclosures*.

In the circumstances we feel it would best help readers if we divided the chapter into two parts. In the first, we will concentrate on the basic principles underlying the issue and discuss the current but soon to be discarded standards. We will in so doing take account of their likely demise, but we need to remember the incremental nature of the developments in accounting standards. It is increasingly difficult fully to understand an accounting standard if one does not have some knowledge of its predecessor or predecessors. In the second part of the chapter, we will outline the contents of FRED 30 and comment on the likely progress of the convergence programme.

## FRS 4 *Capital Instruments*

FRS 4 was the first ASB standard to deal with the issue of accounting for liabilities[2] and, while it is has been announced that it will be withdrawn as part of the convergence programme it still provides a useful introduction to the issues surrounding accounting for financial liabilities, and some appreciation of its contents will greatly assist in understanding the numerous developments that are currently taking place. The convergence programme is bringing about changes in classification and terminology in a number of areas and, in this case, the phrase capital instruments is being replaced by the broader term

[2] Although SSAP 18 dealt with contingent liabilities.

financial instruments, that includes both financial liabilities and financial assets. We will, for convenience, continue to use the term capital instruments in our discussion of FRS 4.

It is instructive to start by considering the objective of FRS 4, which is:

> to ensure that financial statements provide a clear, coherent and consistent treatment of capital instruments, in particular as regards the classification of instruments as debt, non-equity shares or equity shares; that costs associated with capital instruments are dealt with in a manner consistent with their classification, and, for redeemable instruments, allocated to accounting periods on a fair basis over the period the instrument is in issue; and that financial statements provide relevant information concerning the nature and amount of the entity's sources of finance and the associated costs, commitments and potential commitments. (Para. 1)

The paragraph makes specific reference to classification, appropriate measurement and disclosure but makes no mention of recognition. There is a brief discussion of recognition in FRS 5 *Reporting the Substance of Transactions* and the subject is covered in a little more depth in Chapter 5 of the *Statement of Principles*.

We should start by defining the term *capital instruments*.

> **All instruments that are issued by reporting entities which are a means of raising finance, including shares, debentures, loans and debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments. In the case of consolidated financial statements the term includes capital instruments issued by subsidiaries except those that are held by another member of the group included in the consolidation. (Para. 2)**

Another important definition is that of *finance costs*. These are:

> **The difference between the net proceeds of an instrument and the total amount of the payments (or other transfers of economic benefits) that the issuer may be required to make in respect of the instrument. (Para. 8)**

With these two definitions in mind the main points of FRS 4 can be summarised.

## Balance sheet presentation

Capital instruments must be categorised into four groups for single companies and or six groups for consolidated financial statements as shown in Table 8.1.

**Table 8.1 Categorisation of capital instruments**

| | *Analysed between* | |
|---|---|---|
| Shareholders' funds | Equity interests | Non-equity interests |
| Liabilities | Convertible liabilities | Non-convertible liabilities |
| Minority interests in subsidiaries | Equity interests in subsidiaries | Non-equity interests in subsidiaries |

The period prior to the issue of FRS 4 had seen the issue of various hybrid forms of capital instruments that seemed to combine elements of debt and equity. Examples of the hybrid securities are convertible bonds where holders are given the right to convert into equity shares at a favourable price at some future time. Often the terms are such that the conversion is virtually certain to occur and existing shareholders benefit from obtaining

capital at a relatively low rate of interest until conversion, when their ownership interest in the company is diluted.[3]

Because of their complexity, and the lack of a clear accounting standard, there was inconsistency in treatment and opportunities, which were from time to time taken, to paint the balance sheet in a more favourable light than reality might otherwise have allowed. All other things being equal, the higher the level of debt relative to shareholders' funds the higher the degree of risk, because failure to pay interest could lead to the insolvency of the company, whereas the failure to pay dividends would not have such a devastating effect. Similarly, from the point of view of equity shareholders, a high level of non-equity shares means that equity holders are subject to greater uncertainty in terms of their returns because of the prior claims of the non-equity holders. Hence the opportunity of painting the balance sheet in a rosy hue if there are possibilities that instruments which are essentially debt can be presented as part of shareholders' funds, or if non-equity interests can be classified as part of equity shares. As will be seen, the provisions of FRS 4 are such as to ensure that if an instrument contains any element of debt it should be treated as debt or, if the instrument is properly part of shareholders' funds, then, if the instrument contains any trace of non-equity, it should be recorded as non-equity.

## Allocation of finance costs

Finance costs associated with liabilities and shares, other than equity shares, should be allocated to accounting periods at a constant rate on the carrying amount. This is the actuarial method that is illustrated in the examples that follow. Initially capital instruments should be recorded at the net amount of the issue proceeds and only the direct costs incurred in connection with the issue of the instruments should be deducted from the proceeds in arriving at this net amount. The finance cost for the period is added to the carrying amount and payments deducted from it. Thus, as will be seen, the carrying figure in the balance sheet may not be the same as the nominal value of the liability, but in the case of redeemable instruments this would result in the carrying amount at the time of redemption being equal to the amount payable at that time. Gains and losses will only occur on purchase or early redemption and the standard specifies clearly how these should be treated.

> Gains and losses arising on the repurchase or early settlement of debt should be recognised in the profit and loss account in the period during which the repurchase or early settlement is made. (FRS 4, Para. 32)

Accrued finance costs, to the extent that they will be paid in the next period, may be included with accruals, but even if this option is exercised, the accrual must be included in the carrying value for the purpose of calculating the finance costs and any gains or losses on repurchase or early settlement (FRS 4, Para. 30).

In some cases the amount payable on the debt may be contingent on uncertain future events such as changes in a price index. Such events should not be anticipated and the finance costs and carrying amount should only be adjusted when the event occurs (FRS 4, Para. 31).

[3] For an introduction to these hybrid forms of financial instruments, readers are referred to D.J. Tonkin and L.C.L. Skerratt (eds), *Financial Reporting 1988–1989*, ICAEW, 1989: chapter entitled 'Complex Capital Issues', by B.L. Worth and R.A. Derwent; and L.C.L. Skerratt and D.J. Tonkin (eds), *Financial Reporting 1989–1990*, ICAEW, 1989: chapter entitled 'Complex Capital Issues'.

We shall illustrate both the actuarial method specified in FRS 4 and the conflict between the provisions of the standard and the more economically illiterate aspects of company legislation by considering the example of the issue of three hypothetical debentures under terms that look more different than they actually are.

## Example 8.1

Let us consider three issues of debentures, each with a nominal value of £100 and each for a five-year period.

(a) Debenture A carries a coupon rate of 20 per cent per annum: it is to be issued and redeemed at par.
(b) Debenture B carries a coupon rate of 16 per cent per annum: it is to be issued at a discount of £12, at a price of £88, and is to be redeemed at par.
(c) Debenture C carries a coupon rate of 18 per cent per annum: it is to be issued at par but redeemed at a premium of £15 at £115.

We shall assume that the interest on each debenture is payable annually at the end of each year and shall ignore taxation and transaction costs.

The effective interest rate on Debenture A is 20 per cent and the terms of Debentures B and C have been chosen to produce identical effective interest rates of 20 per cent. In other words, if we discount the cash flows from and to the debenture holders, all these debentures produce a net present value (NPV) of zero at a 20 per cent discount rate (Table 8.2).

**Table 8.2 Net present values of debentures**

| *Debenture* | *NPV at 20%* |
|---|---|
| A | $+100 - 20a_{\overline{5}|} - 100v^5$ |
| | $= +100 - 20(2.9906) - 100(0.4019)$ |
| | $= +100 - 59.8 - 40.2$ |
| | $= 0$ |
| B | $+88 - 16a_{\overline{5}|} - 100v^5$ |
| | $= +88 - 16(2.9906) - 100(0.4019)$ |
| | $= +88 - 47.8 - 40.2$ |
| | $= 0$ |
| C | $+100 - 18a_{\overline{5}|} - 115v^5$ |
| | $= +100 - 18(2.9906) - 115(0.4019)$ |
| | $= +100 - 53.8 - 46.2$ |
| | $= 0$ |

In all cases the effective rate of interest, that is the cost of the finance, is 20 per cent, but whereas for Debenture A this is all paid in interest, for Debentures B and C the cost is partly paid as a difference between the redemption price and the issue price.

Accounting for Debenture A poses no problems. The annual interest expense of £20 (20 per cent of £100) will be charged in the profit and loss account each year, while the liability will appear at the nominal value of the debentures, that is £100. Accounting for Debentures B and C does pose some problems and we will deal with each in turn.

**Discount on debentures**

Debenture B is issued at a discount. While the interest of £16 (16 per cent of £100) will undoubtedly be charged to the profit and loss account each year, it is also necessary to decide how to account for the discount on issue, the amount of £12.

The liability would be recorded at the nominal value of £100 and company law permits us to treat the discount on debentures as an asset.[4] Once we have recorded the discount as an asset, the next question is how this should be dealt with. As the discount is effectively part of the cost of the finance, we might expect this cost to be reflected in the profit and loss account. However, company law specifically permits the writing off of discounts on debentures to a share premium account.[5]

Thus, where a company has a share premium account, we may either write off the discount to the share premium account or we may write off the discount to the profit and loss account. In the latter case it is possible to write off the discount immediately or to write it off over the five-year period. Let us look at each possibility in turn.

**Use of share premium account**

Although company law clearly permits the writing off of this discount to the share premium account, this results in part of the cost of borrowing bypassing the profit and loss account and hence in an overstatement of profits. This odd quirk of company law has been around for some time, as have its critics.

As long ago as 1962, the Jenkins Committee, which was set up to advise the government on changes in company legislation, reported that it thought that the law should be amended:

> . . . to prohibit the application of the (share premium) account in writing off the expenses and commission paid and discounts allowed on any issue of debentures or in providing for any premiums payable on redemption of debentures, since these are part of the ordinary expenses of borrowing.[6]

Despite the numerous Companies Acts that have been enacted since 1962, this oddity remains and it is difficult to see how it can be justified. The charging of a discount to the share premium account means that the profit and loss account does not bear the full cost of the borrowing, but it also seems to be inconsistent with the rationale for creating a share premium account in the first place. The purpose of a share premium account is to ensure that, with certain exceptions, subscribed capital cannot be repaid to shareholders. If the profit and loss account is relieved of part of the cost of the business, then, effectively, part of the subscribed capital is available for distribution.

**Charge to profit and loss account**

If it is to be charged to the profit and loss account the 1985 Act merely states that 'it shall be written off by reasonable amounts each year and must be completely written off before repayment of the debt'.[7]

However FRS 4 requires that the 'finance cost of debt should be allocated to periods over the term of the debt at a constant rate on the carrying amount'.[8]

Using the actuarial method[9] the liability is recorded at the present value of the cash flows discounted at the market rate of interest, which we have assumed to be 20 per cent. The interest expense each year would be found by multiplying the present value of the cash flows at the start of the year by the effective interest rate. As can be seen from Table 8.3 this results in an increasing liability and an increasing interest expense throughout the term of the loan.

[4] Companies Act 1985, Schedule 4, Para. 24(1).
[5] Companies Act 1985, s. 130(2).
[6] Report of the Company Law Committee, Cmnd. 1749, HMSO, London, 1962, Para. 163.
[7] Companies Act 1985, Schedule 4, Para. 24(2)(a).
[8] FRS 4, Para. 28.
[9] Which is also called the effective rate method, the 'compound yield method' (Inland Revenue) or the 'interest method' (FASB).

**Table 8.3 Actuarial method for Debenture B**

| *(i)* *Year* | *(ii)* *Opening balance* | *(iii)* *Interest 20% of (ii)* | *(iv)* *Total (ii) + (iii)* | *(v)* *Payment at year end* | *(vi)* *Closing balance (iv) – (v)* |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| 1 | 88.0 | 17.6 | 105.6 | 16.0 | 89.6 |
| 2 | 89.6 | 17.9 | 107.5 | 16.0 | 91.5 |
| 3 | 91.5 | 18.3 | 109.8 | 16.0 | 93.8 |
| 4 | 93.8 | 18.8 | 112.6 | 16.0 | 96.6 |
| 5 | 96.6 | 19.4* | 116.0 | 116.0† | – |

* Includes rounding adjustment. † Interest 16.0 + Redemption price 100.0.

In addition to satisfying the requirements of FRS 4 this is the approach that is required in the USA[10] and by SSAP 21 *Accounting for Leases and Hire Purchase Contracts* when accounting for the obligation under a finance lease (see Chapter 9).

**Premium on redemption**

Debenture C, which carries a coupon rate of interest of 18 per cent is issued at par but redeemed at a premium of £15. Under the existing legal framework it is not clear whether the liability should be recorded initially at the nominal value of £100 or at the amount payable, the redemption price of £115. If it is recorded initially at £100, then a premium must be provided by the end of the five-year period. If it is recorded initially at £115, then an asset 'premium on debentures' must also be established and we have a situation analogous to the issue of a debenture at a discount that has been discussed above. In either case it is necessary to decide how to deal with the premium.

Not surprisingly we find that the law permits the write-off of this premium to share premium account but, for the reasons explained above, the authors are of the view that it should be charged to the profit and loss account over the life of the debentures. Using the actuarial method the liabilities at the balance sheet dates and the annual expense figures can be calculated as shown in Table 8.4.

**Table 8.4 Actuarial method for Debenture C**

| *(i)* *Year* | *(ii)* *Opening balance* | *(iii)* *Interest 20% of (ii)* | *(iv)* *Total (ii) + (iii)* | *(v)* *Payment at year end* | *(vi)* *Closing balance (iv) – (v)* |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| 1 | 100.0 | 20.0 | 120.0 | 18.0 | 102.0 |
| 2 | 102.0 | 20.4 | 122.4 | 18.0 | 104.4 |
| 3 | 104.4 | 20.9 | 125.3 | 18.0 | 107.3 |
| 4 | 107.3 | 21.5 | 128.8 | 18.0 | 110.8 |
| 5 | 110.8 | 22.2 | 133.0 | 133.0* | – |

* Interest 18.0 + Redemption price 115.0.

[10] Readers are referred to Richard Macve, 'Accounting for long-term loans', in *External Financial Reporting*, Bryan Carsberg and Susan Dev (eds), Prentice-Hall, Englewood Cliffs, NJ, 1984. This essay in honour of Professor Harold Edey discusses the treatment of long-term loans in both the UK and the USA.

## Finance costs for non-equity shares

The treatment of finance costs relating to non-equity shares is based on the same principles as debt (FRS 4, Para. 42), with two additional specific rules. These are:

> Where the entitlement to dividends in respect of non-equity shares is calculated by reference to time, the dividends should be accounted for on an accruals basis except in those circumstances (for example where profits are insufficient to justify a dividend and dividend rights are non-cumulative) where ultimate payment is remote. All dividends should be reported as appropriations of profit. (Para. 43)

> Where the finance costs for non-equity shares are not equal to the dividends, the difference should be accounted for in the profit and loss account as an appropriation of profits. (Para. 44)

An example of a situation where there may be a difference between the finance costs and the dividends are shares that may be redeemed at a premium.

We have already introduced the actuarial method and shown that the method is logical and allocates the cost of borrowing fairly over the period of the loan, as well as ensuring that the whole of the finance costs are charged to the profit and loss account. The use of the method would also achieve consistency across a wide range of different capital instruments in issue, including non-equity shares, although, in this case, the provisions of company law, on which FRS 4 is based, would require us to show the cost as an appropriation of profit rather than an expense.

## Issue costs

The calculation of the constant rate of interest and the initial carrying value in the balance sheet depends upon the 'net proceeds' of the issue of the capital instruments. The net proceeds are defined as:

> **The fair value of the consideration received on the issue of a capital instrument after deduction of issue costs. (Para. 11)**

Issue costs are defined as:

> **The costs that are incurred directly in connection with the issue of a capital instrument, that is, those costs that would not have been incurred had the specific instrument in question not been issued. (Para. 10)**

The use of the phrase 'fair value' reminds us that the carrying value of the capital instrument will not always be found without some degree of estimation. An example of such a case would be the joint issue of a debt and warrant when the amount received for the issue of the joint instrument will need to be allocated to provide the fair value of the debt and warrant respectively. The most likely source of evidence would be the market values of similar securities.

The standard is restrictive as to what should be included in issue costs (Para. 96). Such costs should not include any which would have been incurred had the instrument not been issued, such as management remuneration or indeed the costs of researching and negotiating alternative sources of finance. Those costs that do not qualify as issue costs should be written off to the profit and loss account as incurred. The standard requires that issue costs be accounted for by reducing the proceeds of the issue of the instrument and should not be regarded as assets because they do not provide access to any future economic benefits. The

consequence of setting the issue costs against the proceeds is to increase the interest charge in the profit and loss account; in other words, it ensures that the issue costs are written off over the life of the capital instrument.

## Use of the share premium account

It might be thought that the provisions of FRS 4 would include the stipulation that entities subject to the Companies Act should no longer take advantage of the provision whereby they can charge issue costs and discounts against the share premium account. They only go some way towards this desirable end. Issue costs, which would include discounts, have to be charged to the profit and loss account but the standard specifically draws attention to the fact that the issue costs may subsequently be charged to the share premium account by means of a transfer between reserves (Para. 97).

## The distinction between shareholders' funds and liabilities

A capital instrument is a liability if it contains an obligation to transfer economic benefit, including contingent obligations, otherwise it is part of shareholders' funds. It is usually clear whether an instrument requires the company to make some sort of transfer to the owner of an instrument or whether any such transfer is made at the discretion of the company, but there are two exceptions to the general rule. The first relates to an obligation that would only arise on the insolvency of the issuer. If there is no expectation of that event, and the entity can be accounted for on a going concern basis, that contingent liability can be ignored. Similarly, an obligation that would only crystallise if a covenant attached to a capital instrument were breached can also be disregarded unless, of course, there is evidence that such a breach will occur.

Some preference shares effectively impose an obligation on the issuing entity to transfer economic benefit, that is pay a dividend, because to do otherwise would be even more costly. Until now, these economic facts have been disregarded and, if capital instruments were called preference shares, they automatically appeared in the owners' equity section of the balance sheet. FRED 30 proposes that in cases where the payment of a dividend is, in practice, unavoidable, the instrument be treated as a liability. Thus, as in many areas of accounting, substance would have to take precedence over form.

### Warrants

Share warrants are instruments that state that the holder or bearer is entitled to be issued with a specified number of shares, possibly upon the payment of an additional fixed price. In the view of the ASB, the original amount paid for the warrant must be regarded as part of the subscription price of the shares which may, or may not, be issued at some time in the future, and it is for this reason that FRS 4 specifies that warrants be reported within shareholders' funds (Para. 37).

The Board does, however, recognise that the topic of warrants raises a number of issues that are outside the scope of FRS 4. It refers[11] in particular to the view that, if the price paid on the exercise of the warrant is less than the fair value of the shares issued, this should be reflected in the financial statements by, presumably, increasing shareholders' funds and recognising as an expense the 'cost' incurred in issuing shares in this way. Another contro-

versial issue is what should be done if the warrant lapses without being exercised. Should the amount initially subscribed to the warrant continue to be treated as part of share capital or be regarded as a gain by the company? The issue depends essentially on whether the warrant holders are regarded as sharing in the ownership of the company. If they are so regarded then the benefit from the lapse in the warrant is not a gain to the company but a transfer between owners, and hence the initial subscription should be treated as part of share capital. If, on the other hand, the warrant holders are not regarded as owners (the view taken by the ASB), the amount released by the lapse of the warrants should be reported as a gain within the statement of recognised gains and losses.

In summary, the provisions of FRS 4 relating to the taking up and lapsing of warrants are:

1 When a warrant is exercised, the amount previously recognised in respect of the warrant should be included in the net proceeds of the shares issued (Para. 46).
2 When a warrant elapses unexercised, the amount previously recognised in respect of the warrant should be reported in the statement of total recognised gains and losses (Para. 47).

## The distinction between equity and non-equity

FRS 4 reinforces the requirements of company law by requiring that the balance sheet should show the total amount of shareholders' funds with an analysis between the amount attributable to equity interests and the amount attributable to non-equity interests (Para. 40).

The need therefore is to distinguish between equity and non-equity interests. Company law provides a succinct definition of equity share capital, which means in relation to a company, its issued share capital excluding any part of that capital which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution.[12]

The ASB believes that this definition does not give sufficient guidance in the more complex cases and hence it provides a far more detailed statement of the distinction that starts with a definition of non-equity shares. These are shares possessing any of the following characteristics:

**(a) Any of the rights of the shares to receive payments (whether in respect of dividends, in respect of redemption or otherwise) are for a limited amount that is not calculated by reference to the company's assets or profits or the dividends on any class of equity share.**
**(b) Any of their rights to participate in a surplus in a winding-up are limited to a specific amount that is not calculated by reference to the company's assets or profits, and such limitation has a commercial effect in practice at the time the shares were issued or, if later, at the time the limitation was introduced.**
**(c) The shares are redeemable according to their terms, or the holder, or any party other than the issuer, can require their redemption. (Para. 12)**

Following all the above, equity shares are defined simply as 'shares other than non-equity shares' (Para. 7).

The ASB thinking is quite clear. Its definition attempts to ensure that only 'true' equity is treated as such. In so far as the existence of non-equity capital represents a risk that may be taken into account by equity shareholders when making investment decisions, this approach can be seen as being protective of the interest of existing and potential equity shareholders.

As stated earlier, the provisions of FRED 30 would sensibly lead to the reclassification of some non-equity shareholders' funds as liabilities.

[11] See the section on the development of the standard, Paras 11–13.
[12] Companies Act 1985, s. 744.

## The distinction between convertible and non-convertible liabilities

A convertible debt is one that allows the holder of the security to exchange the debt for shares in the issuing company on the terms specified in the debt instrument.

Prior to the issue of FRS 4, existing practice was to report convertible debt as a liability, a practice that FRS 4 noted is uncontroversial where conversion is uncertain or unlikely. But there are those who would argue that, if conversion were probable, convertible debt should be reported outside liabilities in order to give a fairer representation of the economic position of the company. In drafting FRS 4, the ASB, arguing that a balance sheet is a record of the financial position of a company at a point of time, not a forecast of future events, specified that all convertible debt should be included with liabilities. As we shall see, in the section of this chapter dealing with the disclosure requirements of the standard, adequate information must be provided regarding the terms and conditions relating to the various capital instruments in issue.

There is a more sophisticated line of argument that suggests that merely reporting convertible debt as part of liabilities ignores the equity rights which are inherent in the issue of convertible debt. As we shall see, the IASC, in IAS 32 *Financial Instruments: Disclosure and Presentation*, required split accounting for convertible debt. Under this approach the proceeds of issue of convertible debt are allocated between the two components, the equity rights and the liabilities. The consequence of this is that the finance charge relating to the debt is increased over that which would be recorded if the whole of the proceeds of the issue were treated as a liability. The reason for this is that the total amount payable to the convertible debt holders, assuming no conversion, consists of a string of interest payments and the redemption price remains the same irrespective of the method of accounting used. If the initial recorded value of the debt were smaller, as it would be if the proceeds of the issue were split, then the finance cost would be increased to cover the amount of the proceeds that were allocated to the equity interest.

Happily for lovers of simplicity, the ASB rejected this more complex presentation, although it will emerge if the proposals of FRED 30 are accepted. In the meantime the standard practice for the presentation of convertible debt is straightforward:

> Conversion of debt should not be anticipated. Convertible debt should be reported within liabilities and the finance cost should be calculated on the assumption that the debt will never be converted. The amount attributable to convertible debt should be stated separately from that of other liabilities. (Para. 25)
>
> When convertible debt is converted, the amount recognised in shareholders' funds in respect of the shares issued should be the amount at which the liability for the debt is stated as at the date of conversion. No gain or loss should be recognised on conversion. (Para. 26)

## Debt maturity

As recognised in company legislation, users of accounts need to be given adequate information about the scheduling of the repayment of debt in order to help them assess the companies' short-term solvency and long-term liquidity position.

The requirements of FRS 4 are a little more extensive than those of the Companies Act in that they include an additional cut-off date of two years. The requirement is that:

An analysis of the maturity of debt should be presented showing amounts falling due:

(a) in one year or less, or on demand;
(b) in more than one but not more than two years;
(c) in more than two years but not more than five years; and in more than five years. (Para. 33)[13]

The maturity of the debt should be determined by reference to the earliest date on which the lender can require repayment. (Para. 34)

Life is, of course, not without its complications and the ASB had to consider the case of a borrower who had already made arrangements to refinance the existing loan. The question here is whether the maturity of the loan should be measured by reference only to the capital instrument currently in issue, or whether account should be taken of the re-financing arrangements that have been established. It would clearly be misleading to ignore the significant fact that facilities have been established in order to extend the period of the loan. Therefore the ASB states:

Where committed facilities are in existence at the balance sheet date that permit the refinancing of debt for a period beyond its maturity, the earliest date at which the lender can require repayment should be taken to be the maturity date of the longest refinancing permitted by a facility in respect of which all the following conditions are met:

(a) The debt and the facility are under a single agreement or course of dealing with the same lender or group of lenders.
(b) The finance costs for the new debt are on a basis that is not significantly higher than that of the existing debt.
(c) The obligations of the lender (or group of lenders) are firm: the lender is not able legally to refrain from providing funds except in circumstances the possibility of which can be demonstrated to be remote.
(d) The lender (or group of lenders) is expected to be able to fulfil its obligations under the facility. (Para. 35)

This is clearly a stringent set of conditions.

In order that the users of the accounts are made aware of the use of the above provision it is also required that:

Where the maturity of debt is assessed by reference to that of refinancing permitted by facilities in accordance with paragraph 35, the amounts of the debt so treated, analysed by the earliest date on which the lender could demand repayment in the absence of the facilities, should be disclosed. (Para. 36)

## FRS 4 and consolidated financial statements

There are a number of special issues relating to consolidated financial statements.

There may be circumstances when shares issued by a subsidiary and held outside the group should be included in liabilities rather than minority interest (Para. 49). This treatment is required when the group, taken as a whole, has an obligation to transfer economic benefit; for example, if another member of the group has guaranteed payments relating to the shares.

[13] This is a correction of the original version that was effected in FRS 13. The original, incorrect, version referred to periods of less than 2 or 5 years and more than 2 or 5 years, thus leaving in doubt the treatment of liabilities that had exactly two or five years to run.

In addition:

(a) The amount of minority interests shown in the balance sheet should be analysed between the aggregate amount attributable to equity interests and amounts attributable to non-equity interests (Para. 50).
(b) The amounts attributed to non-equity minority interests and their associated finance costs should be calculated in the same manner as those for other non-equity shares. The finance costs associated with such interests should be included in minority interests in the profit and loss account (Para. 51).

Some further explanation is required regarding the circumstances under which shares issued by subsidiaries would not be shown in minority interest. As already noted, one of the FRS 4 principles is that if any element of obligation to transfer economic resources attaches to a capital instrument, then it should be treated as a liability. Thus, if guarantees have been given in respect of dividends payable on the shares or on their redemption, there is a liability, albeit contingent, to transfer economic resources. In such circumstances the shares should be included under liabilities.

## Disclosure requirements

FRS 4 is very much concerned with the provision of adequate, some might argue more than adequate, disclosure, and, in the previous pages, we have referred to a number of the proposals that bear on this matter. The remaining disclosure requirements may be summarised as follows:

(a) Disclosure relating to shares (Paras 55–59)
    (i) An analysis should be given of the total amount of non-equity interests in shareholders' funds relating to each class of non-equity shares and series of warrants for non-equity shares.
    (ii) A brief summary of the rights of each class of shares should be given, other than for equity shares with standard characteristics. Details should also be provided of classes of shares which are not currently in issue but which may be issued as a result of the conversion of debt or the exercise of warrants.
    (iii) Details of dividends for each class of shares and any other appropriation of profit in respect of non-equity shares should be disclosed.
(b) Disclosure relating to minority interests (Paras 60–61)
    (i) The minority interests charge in the profit and loss account should be analysed between equity and non-equity interests.
    (ii) If there are non-equity minority interests the rights of the holders against other group companies should be described.
(c) Disclosure relating to debt (Paras 62–64)
    (i) Details of convertible debt should be provided.
    (ii) Brief descriptions should be provided where the legal nature of the instrument differs from that associated with debt; for example, when the obligation to repay is conditional.
    (iii) Gains and losses on the repurchase or early settlement of debt should be disclosed in the profit and loss account as separate items within or adjacent to 'interest payable and similar charges'.

(d) General disclosure requirements
  (i) When the disclosure requirements relating to the amounts of convertible debt, non-equity interests in shareholders' funds and non-equity interests in minority interests are given in the notes, the relevant balance sheet caption should refer to the existence of the relevant capital instruments (Para. 54).
  (ii) Where the brief summaries required in respect of a(ii), b(i), c(i) and c(iii) above cannot adequately provide the information necessary to understand the commercial effect of the relevant instruments, that fact should be stated together with particulars of where the relevant information may be obtained. In any event the principal features of the instruments should be stated (Para. 65).

## Application notes

FRS 4 includes a section on Application Notes that describes how the principles of the reporting standard should be applied to capital instruments with certain features. The instruments covered in this section are:

- Auction market preferred shares (AMPS)
- Capital contributions
- Convertible capital bonds
- Convertible debt with a premium put option
- Convertible debt with enhanced interest
- Debt issued with warrants
- Deep discount bonds
- Income bonds
- Index-linked loans
- Limited recourse debt
- Participating preference shares
- Perpetual debt
- Repackaged perpetual debt
- Stepped interest bonds
- Subordinated debt

Space does not allow coverage of these notes and the interested reader should refer to the standard itself.

# Hedge accounting

Amongst the reasons why the subject of accounting for liabilities has become far more interesting are the developments in the area of hedging.

A hedging transaction, or a hedge, is a way of reducing risk associated with an investment that the entity has made or contract that it has made; this is known as *the hedged item*. The hedge involves the entity entering into another contract, *the hedging instrument*, whose cash flow will vary inversely with those of the hedged item. A simple example would be an entity that wants to make a substantial investment, say in a building, in country A but is very concerned about the loss it would make if there was a substantial fall in the value of the currency of that country. It may have powerful strategic reasons to make such an investment but might be in a position that could not cope with a substantial loss. It could reduce the extent of any potential loss by investing in a contract whereby it would gain if the value of the currency falls. If the market did not share the entity's pessimism about the long-term value of the currency, it could enter the foreign currency market and agree to sell *x* million units of the currency of country A in six months' time. If the currency were to fall it would cost the entity less to acquire the agreed amount of the currency and the greater the fall the greater would be the gain. More complex packages could involve more than one hedge instrument.

Hedge accounting comes into play when the application of the normal accounting rules would mean that the gain or loss on the hedged item would be recognised in a different period to the offsetting gain or loss on the hedge instrument or instruments. There is obviously strong pressure to show the net impact of a hedging operation in one accounting period but to do so might involve breaking the normal rules, hence the need to consider whether, and if so to what extent, the normal rules should be 'adjusted' to reflect the fact that the transactions are part of a hedging operation.

## FRED 23 *Financial Instruments: Hedge Accounting*

The objective of any standard based on FRED 23, issued in May 2002, would be to establish principles for the use of hedge accounting when accounting for financial instruments.

FRED 23 proposes that, in order for a financial instrument to qualify for hedge accounting, two criteria have to be met: a hedging relationship and hedge effectiveness.

1 *Hedging relationship*: A hedge cannot be created in arrears: there must be formal documentation of the hedging relationship available at the date of its inception. The effectiveness of the hedge must be capable of reliable measurement and, if a forecast transaction is being hedged, it must be highly probable and must present an exposure to variations in cash flows that could ultimately affect reported net profit or loss.

2 *Hedge effectiveness*: The effectiveness of a hedge is related to the achievement of the hedging instrument or instruments in generating changes in fair values or cash flows that offset those relating to the hedged item. In order to satisfy the requirements of FRED 23, the hedge must both be expected to be effective at the outset and prove to be effective during its life. The draft states that a hedge is effective if the extent of the offset lies between 80 per cent and 125 per cent.

The introduction to the exposure draft points out that hedge accounting takes many forms and the purpose of a standard based on it would not require or prohibit the adoption of any particular form of hedge accounting.[14] It would, however, cover three areas:

### Hedges for net investment on foreign operations

The part of any gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised in the statement of total recognised gains and losses and be treated in the same way as the gains and losses on the hedged item while the part of the gain or loss which is not an effective hedge should be reported in the profit and loss account (Para. 16).

### An ineffective hedge

An ineffective portion of any hedge would have to be recognised immediately in the profit and loss account (Para. 16).

[14] FRED 23, p. 10.

### Terminated hedges

If hedge accounting is terminated because the transaction that was hedged is no longer expected to occur the loss or gain on the hedge should be recognised immediately in the profit and loss account. If it is terminated for another reason, the loss or gain should be recognised immediately in the profit and loss account, or the statement of total recognised gains and losses, so as to offset the gains and losses on the hedged item (Para. 17).

## Derivatives

This is an area where reasonably simple concepts are made complex by the use of technical terminology; some might call it jargon. So let us start with the basic definition:

> **A derivative instrument is one whose performance is based (or derived) on the behaviour of the price of an underlying asset (often simply known as the 'underlying'). The underlying asset itself does not need to be bought or sold. A premium may be due.[15]**

Let us start by considering one of the simplest forms of derivative, an *option*. Under a *call* option, the purchaser pays a sum of money in order to have the right to purchase shares at an agreed price at some point in the future. Under a *put* option, the purchaser has the right to sell shares at the agreed price at some time in the future.

Let us look at an example of a call option. Suppose that, in May, the price of the shares of Gambling plc are £3 each and an investor, who believes that the share price will increase considerably, pays 40 pence a share for the right to buy 1000 shares in October at £4.50 each, the *strike price*. If, in October, the price of the shares exceeds £4.50 by a sufficient margin to cover the price paid for the option and other transaction costs, the purchaser of the option will gain because he or she could buy the shares at £4.50 and then sell them at the then current market price. If the price falls between £4.50 and £4.90, it would still be worth buying the shares, although the investor would not cover the price paid for the option.

The 40 pence will be the price of the option as determined by the market. While most markets now employ electronic trading, derivatives trading is still carried out in bull pits by people wearing different coloured jackets communicating through hand signals. Most books on derivatives paint this rather charming scene before moving on to some pretty heavy mathematics.

The value of the option will constantly vary and will depend largely on two factors:

- the difference between the strike price and the current price of the share, *the underlying price*;
- the volatility of the underlying price, which is usually derived from a formula that is related to the history of the share's price movements.

It would be rare for anyone to hold a single option, unless it is part of a hedging operation, for options will normally be held as part of a portfolio of similar derivatives which will, according to the degree of risk averseness exhibited by the owner, be a balanced one that seeks to attempt to minimise the possibilities of making considerable losses but which also means that there is a lesser chance of making vast profits. But, of course, the great thing about options is that, so long as there is an active market, buyers can change their minds and sell the option or buy more options.

[15] Francesca Taylor, *Mastering Derivatives Markets*, FT/Pitman Publishing, London 1996, p. 2.

Another factor affecting value is the terms on which the option can be exercised and, in particular, whether it can only be exercised on the expiry date of the agreement, a *European* option, or at any time up to and including the expiry date, an *American* option.

There are basically two types of operators in the derivatives market, *hedgers* and *traders*. A hedger is someone who has a position to cover. For example, a company that has made a major investment in a project denominated in an overseas currency and is concerned that the currency may fall in terms of its own currency, might purchase a put option to sell a quantity of the overseas currency, that it does not own, at the current price. If the currency falls, the loss the company would make in converting its overseas remittances from the project would be offset by the gain from the put option. A trader is one who is interested in making money from trading in derivatives, and lest traders are thought to be in some way less worthy than hedgers it must be remembered that without the traders there would be at best a very illiquid market for derivatives.

This is not the place to provide a lengthy introduction to the market for derivatives although we should point out that is, in numerical terms, huge. Even in 1996 it was estimated that the derivatives market was at $30 trillion (that means 13 noughts), which would have made it three times as large as the then global equity market.[16] But it might be helpful to outline some of the main types of derivatives and explain some of the more important terms that are found in this jargon-laden industry.

The four primary derivative markets are:

- Equities
- Foreign exchange
- Commodities (such as energy, metals and agricultural goods)
- Interest rates

Some derivatives, especially those for interest rates, take the form of swaps, a term that would readily be understood by most school children. Take as example two companies both of which have a good reputation in their home country and hence can borrow at more advantageous terms than can others, especially overseas companies. Suppose that the two companies also operate in the home country of the other and both want to borrow money in the overseas country. The swap occurs when each company borrows at the advantageous terms from which it benefits in its home country and they exchange the benefits between them.

A futures contract is one that involves an agreement to deliver a stated quantity of a given commodity in return for a pre-arranged price at some future date. A farmer, for example, concerned that the price of his crop might fall because of a glut, might agree to sell his crop in advance of production for a price that will reflect the overall market view of the trend of market prices. In other words, the hedger has brought certainty while the trader has assumed the risk. The trader will probably not continue to carry the risk for the whole of the time it takes to grow the crop, as the futures contract is likely to be traded frequently as different views are formed as to the likely price.

Options differ from futures and swaps in that they involve the payment by one of the parties of a premium. The importance of a premium is that it allows the holder not to go ahead with the transaction if he believes that to do so would not be in his best interest. The purchaser of a call option where a premium is paid does not have to buy the shares. In contrast the parties to futures contracts have no choice; both must deliver their sides of the bargain.

[16] Francesca Taylor, *Mastering Derivatives Markets*, FT/Pitman Publishing, London, 1996, p. xii.

## The valuation of financial instruments

It would be something of an understatement to observe that there is a lack of consensus on the appropriate accounting treatment of financial instruments.

On the whole, but there are exceptions, standard setters seem to be moving towards the market value approach, especially in respect of derivatives. Thus, in a paper prepared by the Financial Instruments Joint Working Group (JWG)[17] and published in 2000,[18] the view was expressed that virtually all financial instruments should be measured at fair value and that virtually all gains and losses arising from changes in fair value should be recognised in the profit and loss account. The US Financial Accounting Standards Board require derivatives to be shown at market value[19] while the present draft of IAS 39, *Financial Instruments: Recognition and Measurement* would require all derivatives and other financial instruments held for trading, together with any financial assets that are available for sale, to be measured at fair value. As we will see later in this chapter, the ASB is not yet prepared to charge quite as fast down the fair value track.

Those who advocate the use of fair values believe that using them would better represent the effect that a company's use of derivatives and other financial instruments have had on its operations, in the sense that users might see the extent to which a market-related value of a subset of the company's assets and liabilities have moved. Those who would prefer to see a cost-based valuation approach applied to financial instruments feel that the adoption of a fair value basis would lead to greater volatility in reported earnings that might well distort the underlying pattern of trading results. These people who tend to be bankers and corporate treasurers, do not want to see their reported results distorted, for example by wide swings in stock market prices; they would prefer to wait until the actual results of hedging or financial operation are known before disclosing the results.

The fair value approach does seem more appropriate for the financial trading company whose rationale is to live, or die, through its financial activities than it is for other companies whose financial activities are to support their main business. Thus there are those who favour a dual regime using different bases for different types of company and this is, in effect, the position taken by the ASB in FRED 30.

But perhaps there is a simple way out of the argument? The authors have long been amongst those who argue that entities should be required to provide the values of their assets on more than one basis of valuation, for example replacement cost and net realisable value. The usual reason for the rejection of this idea is the, rather patronising, assertion that this would confuse the users of accounts. It is difficult to see how this argument can be used against the proposal that financial instruments be shown on the basis of cost and their fair value. Any user who understands and can appreciate the messages contained in financial statements about derivatives and other financial instruments should not be confused by the presentation of two bases of valuation. They both have messages to tell and users should be able to interpret both and appreciate that their interpretation of those messages should in part depend on the nature of the business of the company whose financial statements they are reviewing.

[17] The JWG was comprised of representatives or members of accounting standard setters or professional bodies drawn from Australia, Canada, France, Germany, Japan, New Zealand, the five Nordic countries, the UK, the USA and the International Accounting Standards Committee.

[18] Draft standard *Financial instruments and similar items*, Joint Working Group.

[19] SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*.

This view accords with the position taken by the majority in a survey of members of the Association of Corporate Treasurers, who believed:

- a mixed model of cost and fair value accounting for derivatives will always be overcomplicated;
- an accounting standard on derivatives that people are trying to apply to both financial and non-financial institutions will never meet the requirements of both;
- the accounting of derivatives should remain at cost; the disclosure should include sufficient information on a company's risk management policies and fair value information to allow investors accurately to understand a company's treasury performance.

Only a small number of respondents were in favour of the JWG approach that all derivatives should be shown at fair value.[20]

The view that a much more useful picture can be provided by narrative disclosure has much to commend it, especially in areas where the selection of a single figure for inclusion in the financial statements must perforce present an incomplete story.

Mention of the narrative approach brings us neatly to FRS 13 *Derivatives and other Financial Instruments: Disclosure*. It would have been impossible at the time FRS 13 was published, September 1998, for the ASB to have produced a standard that dealt with the method of valuing derivatives and similar financial instruments, so a standard was produced that laid down the information that should be provided that would help users to understand what was happening, and in particular the risks to which the company is subject, rather than specifying the basis on which amounts should appear in the financial statements. At the time of issue, it was thought that FRS 13 was an interim standard that would be replaced as accounting standard-setting technology advanced, allowing the framing of regulations that specified the basis on which figures should appear in the financial statements. While this view is partly true, the use of narrative reporting that was, in a way, pioneered by FRS 13 is also likely to be developed and improved.

## FRS 13 *Derivatives and other Financial Instruments*

### Disclosures

This standard is unusual in a number of ways. Not only is it the most complicated standard issued to date, containing many terms and concepts which do not impinge on the professional life of the vast majority of accountants, but also it is an admission that the then (1998) state of the art of financial accounting was not capable of dealing adequately with the reporting of the more complex forms of derivatives and other types of financial instruments. The ASB's concerns were expressed in a discussion paper, *Derivatives and other Financial Instruments*, issued in July 1996, which focused on three main issues: the measurement of financial instruments, the use of hedge accounting and the disclosures relating to financial instruments. Among what FRS 13 describes (p. 137) as the tentative conclusions of the discussion paper was the view that it was not appropriate to measure financial instruments on a historical cost basis, but that they should be measured at fair value. However, the Board was not yet able to advance on the measurement front, nor deal with the issue of hedge accounting, but felt it was necessary to promulgate a standard on disclosure.

[20] Association of Corporate Treasurers, January 2002 Newsletter, **www.treasurers.org**.

## Scope and objective

FRS 13 is concerned only with those entities that have one more of their financial instruments listed or publicly traded on a stock exchange or market as well as all banks and similar institutions. Its provisions do not apply, however, to insurance companies.

A financial instrument is defined in exactly the same terms as it is in the later FRED 30, which we quoted earlier in the chapter, namely:

> **any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. (FRS 13, Para. 2)**

Financial instruments include both primary financial instruments – such as bonds, debtors, creditors and shares – as well *derivative financial instruments*, which are themselves defined in the same section as FRS 13 as:

> **a financial instrument that derives its value from the price or rate of some underlying item.**

The underlying items can take a variety of forms including equities, commodities, interest rates, exchange rates and stock market and other indices.

However, complicated though the nest of interrelations contained within the instrument may be, there must be a chain of events that leads to the transfer of either cash or an equity instrument from one party to another. Thus, just to give a few examples, debtors, shares, forward contracts and options are financial instruments while physical assets, prepayments and obligations, like many warranties that will be satisfied by the provision of services, are not. Lest it be thought that any entity that has debtors will be covered by the standard, remember that to qualify the financial instruments must be publicly traded.

The objective of the standard is to ensure that entities within its scope disclose information to help users assess its objectives, policies and strategy for holding or issuing financial instruments. In particular, the information should help users assess:

> (a) the risk profile of the entity for each of the main financial risks that arise in connection with financial instruments and commodity contracts with similar characteristics; and
> (b) the significance of such instruments and contracts to the reported financial position, performance and cash flows, regardless of whether the instruments or contracts are on the balance sheet (recognised) or off the balance sheet (unrecognised). (Para. 1)

## Risks associated with financial instruments

The standard identifies the following four types of risk associated with financial instruments, of which only the first two have, and even then to a limited extent, been reported upon in financial statements.

- *Credit risk* – the possibility that a party to the contract may fail to perform according to the terms of the contract.
- *Liquidity risk* – the chance that an entity will fail to raise the funds that would enable it to meet its commitments under the contract.
- *Cash flow risk* – the possibility that future cash flows will fluctuate in amount.
- *Market price risk* – the possibility that future changes in market prices will change the value, or burden, of a financial instrument. The main components of market price risk are:
  - *Interest rate risk*
  - *Currency risk*
  - *Other market risk*; this includes the risks associated from changes in commodity and share prices.

## The structure of FRS 13

The standard requires both narrative and numerical disclosures; the same narrative disclosures are required of all entities while the requirement for numerical disclosure differs between:

- entities that are not financial institutions
- banks and similar institutions
- other types of financial institutions.

We are in this section dealing only with the first of the above.

One of the more helpful features of the standard is the three examples it provides in Appendix III, of hypothetical disclosures that might be provided by different entities. One relates to a bank, the others to non-financial entities; of these, one, that is said to be representative of the vast majority of entities, is fairly simple, the other is more complex. Interested readers should refer to this appendix.

## Mode of presentation

It is envisaged, but it is not required, that the disclosures specified by the standard should be placed in the context of a discussion of the entity's activities, structure and funding. This discussion should typically also consider the financial risk profile as a whole. This means that it will be helpful to provide the narrative requirements of the standard in a statement such as an operating and financial review. The way in which the information is presented is left to the entity, but it is required to ensure that the narrative information is cross-referenced to the Notes to the Financial Statements. The required numerical information should be included in the notes.

The standard covers a lot of ground, and large entities with numerous complex schemes, involving many types of financial instrument, could nullify the objective of the standard by providing data in excessive detail. The Board is aware of this point and enjoins entities to be prepared to use a high degree of aggregation in fulfilling their obligations under the standard, which could mean that it might be impossible to relate the explanations directly to the balance sheet captions (another unusual feature of FRS 13), and entities are encouraged to provide additional information to allow the figures to be traced back to the balance sheet unless that would unduly complicate the position (Para. 25).

## Main elements to be disclosed

The length of the standard makes it impossible for us to do anything more than provide a highly simplified and selective summary of the main points that have to be disclosed. In making our selection we have been influenced by those areas, such as the use of current values, that we have emphasised elsewhere in this book. The following are the main aspects for which disclosure is required:

- *Objectives, policies and strategies.*
- *Interest rate disclosures* indicating liabilities at fixed interest rates, variable interest rates and on which no interest is paid.
- *Currency rates disclosure* providing an analysis of the net amount of financial (or monetary) assets and liabilities in terms of the principal currencies involved.
- *Liquidity disclosure*, including a breakdown of the dates at which financial liabilities fall due for payment.
- *Fair value disclosure*, providing information about both the carrying values and fair values of financial assets and liabilities.

- Disclosures about *financial assets and financial liabilities used for trading.*
- Disclosures about *hedging.*
- Disclosures about *commodity contracts.*

## FRED 30 and the convergence programme

As we stated earlier in this chapter the convergence project will have a significant impact on accounting for liabilities, but there remain considerable uncertainties. The two international standards on which UK practice will converge are currently under review while UK company law will need to be changed if the likely changes are to be implemented in the UK.

The situation as at the beginning of 2003 is summarised in Table 8.5.

**Table 8.5 Financial instruments: the current position**

FRED 30 proposes two UK standards:

- *Financial Instruments: Disclosure and Presentation*
- *Financial Instruments: Measurement*

Based on published IASB proposals for revisions to:

- IAS 32 *Financial Instruments: Disclosure and Presentation*
- IAS 39 *Financial Instruments: Recognition and Measurement*

This will lead to the withdrawal of:

- FRS 4 *Capital instruments*
- FRS 13 *Derivatives and other Financial Instruments: Disclosures*

Proposed timetable:

- The revised IAS 32 will be implemented in the UK for all listed companies and all other banks from 1 January 2004.
- The presentation requirements of the revised IAS 32, but not the disclosure requirements, will be implemented in the UK for all unlisted entities, other than those included above from I January 2004.
- The recognition and derecognition requirements of the revised IAS 39 will not be implemented in the UK, but all its other provisions will have to be followed from 1 January 2004 by entities that choose to adopt fair value accounting.

Changes in company legislation will be required; if these are not made in time this timetable will have to change.

Even if the uncertainties are resolved, convergence would not be finally achieved because the ASB is not prepared to accept all the provisions of IAS 32 and 39, as can quickly be demonstrated by a perusal of the two draft statements set out in FRED 30. The starting points for both drafts are the clean versions of IAS 32 and 39, that is, the versions including the proposed changes; these drafts are then 'tracked' to show the additions and deletions that are proposed by the ASB.

In the sections that follow we will use the four-way classification introduced in the previous chapter, that is recognition, measurement, classification (presentation) and disclosure, to outline both the changes that would be made to UK practice if the proposals of FRED 30 were to be implemented and the differences that would still remain between the UK and international standards.

# Changes to UK practice and remaining differences between UK and international standards

## Recognition

### *Changes to current UK practice*

The ASB has concerns about the recognition, and presentation, aspects of IAS 32 and 39 and hopes that the IASB will reconsider these before 2005. Hence the Board is not, at this stage, proposing any changes to the UK standards.

### *Remaining differences between UK and international standards*

The different views on recognition are demonstrated by the fact that the while proposed revision of IAS 39 is entitled *Financial Instruments: Recognition and Measurement*, the proposed FRS omits the word 'recognition', which is not unreasonable given that the proposed UK standard does not contain the relevant paragraphs 27 to 65 of the proposed international standard.

In Appendix III of FRED 30, pp. 297–300, it is pointed out that the ASB's approach to the recognition and derecognition of financial instruments is based on the 'risks and rewards' approach whereby for an asset to be recognised the entity would need to be in a position where it had access to the benefits underlying the asset and was exposed to the risks associated with those benefits; the corresponding features for recognition would be a requirement to pay out benefits, and the associated risk. The IASB approach, as reflected in its proposals for the revision of IAS 39, is different; its view is that the question that needs to be answered is whether the transfer can reverse. If that possibility exists then the asset or liability cannot be derecognised.

The ASB believes that it would be inappropriate to issue a UK standard until the position of the IASB becomes clearer. In the meantime, it is pointed out that, while the underlying principles of the UK and likely international approaches are very different, their application will lead to the same conclusions for many straight-forward transactions.[21]

## Measurement, including hedge accounting

### *Changes to current UK practice*

The changes will impact on measurement and hedge accounting for it is proposed that, with effect from 1 January 2004, if an entity chooses to use *fair value accounting* in preparing its financial statements then it will be required to use, subject to certain modifications, IAS 39's fair value measurement and accounting system.

Let us start by introducing fair value accounting. ASB's understanding, expressed in FRED 30, is that the government would propose to amend legislation to add to the historic cost and the alternative accounting rules a third regime, based on fair value accounting.

The new rules would extend the opportunities for entities to measure certain financial assets and liabilities at fair value and to pass the changes in fair value through the profit and loss account rather than through the statement of total recognised gains and losses.

The exposure draft proposes that entities that adopt the fair value accounting rules, and only those entities, should be required to adopt almost all the measurement and hedge accounting requirements of IAS 39. These entities are likely to be relatively few and specialised, being those, that are not banks or insurance companies, that mark-to-market their trading books and recognise any resulting gains in the profit and loss accounts.

[21] FRED 30, p. 299.

### *Remaining differences between UK and international standards*

At this point we need to return to FRED 23 *Financial instruments: hedge accounting.* FRED 23 and IAS 39 are both based on the same foundations, that is, to qualify for hedge accounting, the hedge needs to be pre-designated and effective. However, IAS 39 goes further than FRED 23 in that it contains additional restrictions on the use of hedge accounting and contains provisions on the type of hedge accounting to be used. As pointed out above, the only UK entities that FRED 30 would require to adopt the more stringent conditions of IAS 39 are the relatively few entities that adopt the fair accounting rules.

Moving to the more general issue of the measurement of financial instruments IAS 39 proposes that all derivatives, all financial instruments held for trading and any financial assets that are available for sale should be measured at fair value. All other financial instruments (i.e. financial assets held to maturity, loans and receivables originated by the reporting entity and all financial liabilities that are neither derivatives nor held for trading) should be measured at amortised cost.[22]

Under the present proposals only those UK entities who choose to make use of the fair value accounting rules would be required to use the IAS 39 measurement rules; other entities would continue on the present basis whereby liabilities are, 'generally speaking, … measured at cost-based amounts rather than at some sort of updated value'.[23]

One other difference would remain between the proposed UK and international standards, and this relates to the important subject of *recycling* that the IASB would allow but which the ASB abhors. Recycling occurs when gains or losses relating to ongoing activities are first recognised in the statement of total recognised gains and losses, or to use the international jargon 'in equity', but which reappear, when, say, a hedge matures, in the profit and loss account. It does seem odd to recognise the same gain or loss more than once and so we hope that the UK position prevails.

## Presentation (disclosure)

### *Changes to current UK practice*

Changes are proposed to balance sheet terminology in that the division between 'shareholders' funds' and 'liabilities' should be replaced by a split between equity and non-equity interests. This has more than a terminological impact because some instruments that are presently treated as being part of shareholders' funds would be treated as a non-equity interest. One example is preference shares. These are in substance liabilities because they were issued on terms that effectively mean that the entity must transfer economic resource to their holders. FRED 30 proposes, in terms of the distinction between debt and equity, that substance should take priority over form and that certain financial instruments that are now included in equity should in the future be treated as a non-equity item.

The effect of the above would be seen not only in the balance sheet, of course, since the amounts paid in respect of preference shares that are in substance liabilities, and treated as such, would be reported as an interest expense rather than dividends. But other changes are being proposed, in that dividends paid and proposed, would no longer appear in the profit and loss account but would instead be disclosed in the reconciliation of movements in shareholders' funds.

It would, of course, only be possible to make the above changes if amendments are made to company legislation.

[22] FRED 30, p. 301.
[23] FRED 30, p. 6.

It is also proposed to make changes to the treatment of convertible debt and to adopt split accounting (see p. 186). The actual split is calculated by reference to market values; thus, in order to estimate the non-equity element of a convertible debt, an estimate would have to be made of the fair value of a similar liability without a related equity element.

While the ASB seems unhappy at the more permissive provisions of IAS 32, as compared to FRS 5 (see p. 211), on the matter of offsetting debits and credits, it has incorporated them into FRED 30. IAS 32 merely requires that the entity does have an enforceable right to set off and the intention to do so. In particular it does not require the right of offset to be capable of surviving the insolvency of the other party.

#### *Remaining differences between UK and international standards*

There are no significant differences between the provisions of FRED 30 and the proposed international standards on this matter.

## Disclosure

#### *Changes to current UK practice*

At present in the UK companies have to publish a range of narrative and numerical risk disclosures relating to their financial instruments, which the ASB describes as 'extensive and relatively detailed'.[24] FRED 30 proposes that these be replaced by those set out in IAS 32 which, although they mirror the UK approach, are less detailed.

#### *Remaining differences between UK and international standards*

There would be no difference in what is to be disclosed but there would be some differences as to who has to disclose. The international standards would apply to all entities. The present UK position is that they should apply only to listed entities and banks and even then, in the case of groups, only to the consolidated financial statements.

## Conclusion

It is to be hoped that the various endeavours to which we referred in this chapter will be achieved by the scheduled dates in order to remove the unnecessary complications from an area which is by its very nature pretty complex. This is not to say, however, that we are confident that matters are moving in the right direction.

We believe that the minds of standard setters, both domestically and internationally, are too firmly fixed on the notion that there is only one solution to every problem, in this case that it is their job is to identify the 'best' accounting treatment for any particular class of transactions. A rather different view is that there is more than one way of portraying reality and that in a number of areas, for example the valuation of financial instruments, a strong case can be made for requiring the valuations to be provided on more than one basis. This would put a greater onus on the users of financial statements, but we believe that it would be better to explain to users why more than one approach to reporting is being adopted rather than present a partial view.

[24] FRED 30, p. 13.

## Summary

We started the chapter by introducing the subject of capital instruments and discussed the contents of FRS 4 *Capital Instruments*. This standard is exclusively concerned with liabilities but we described how attention is now being paid to the broader theme of financial instruments, which covers financial assets as well as liabilities.

The relationship between assets and liabilities is at the heart of hedge accounting, the next topic included in the chapter. Hedge accounting comes into play when transactions are linked and the normal rules controlling the recognition of gains and loses are relaxed so that gains and losses of linked transactions may be recognised in the same period. In this context we summarised the proposals of FRED 23 *Financial Instruments: Hedge Accounting*.

Derivatives are instruments whose performance is based on the price movements of an underlying asset. We described the most widely used forms of derivatives and outlined the arguments that are being advanced in the debate between those who believe that derivatives should be recognised in the financial statements at fair value and those who advocate a cost-based approach. As at January 2003 the only UK standard on derivatives, FRS 13 *Derivatives and other Financial Instruments: Disclosures*, is concerned solely with disclosure issues and says nothing about measurement. We summarised the content of the standard.

The issue of financial instruments, including derivatives, is looming large in the accounting standards convergence programme and we ended the chapter by describing the stance taken by the ASB as reflected in FRED 30, which is an exposure draft for two proposed standards, *Financial Instruments: Disclosure and Presentation* and *Financial Instruments: Measurement*. We outlined the changes that the implementation of the FRED 30 proposals would bring to UK practice as well as the differences that would remain between UK and international standards. The differences are now being addressed as part of the convergence programme – with the added spur for EU members of the 2005 target.

### Recommended reading

E. Bunn, 'Derivatives and hedging' *Corporate Finance*, No. 211, June 2002.

F.J. Fabozzi (ed.), *The Handbook of Financial Instruments*, Hoboken, N.J., Wiley, 2002.

S.G. Ryan, *Financial Instruments and Institutions – Accounting and Disclosure Rules*, Hoboken, N.J., Wiley, 2002.

Excellent up-to-date and detailed reading on the subject matter of this chapter and on much of the contents of this book is provided by the most recent edition of:

*UK and International GAAP*, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Ernst & Young, Butterworths Tolley, London. At the time of writing, the latest edition is the 7th, published 2001.

# Questions

**8.1** (a) **Explain the main reasons for the introduction of FRS 4, Capital instruments.** (7 marks)

(b) **Explain how FRS 4, Capital instruments, deals with the accounting treatment of:**

**(i) convertible debt; and**
**(ii) redeemable preference shares,**

**making reference to any differences with International Accounting Standards. You should relate your comments to the underlying principles in the Statement of Principles, where appropriate.** (9 marks)

(c) Errol plc borrowed £20 million on 1 January 2000 under an agreement with its bank to pay interest of 7% on 31 December 2000, 10% on 31 December 2001 and a final payment of interest and capital totalling £22 057 000 on 31 December 2002. The company prepares accounts to 31 December. Assume an overall effective annual rate of interest of 9%.

**Requirement**
**Calculate and disclose the amounts that will appear on the face of the profit and loss accounts and balance sheets for each year affected by the loan.** (6 marks)

*ICAEW, Financial Reporting, December 2000* **(22 marks)**

**8.2** You are the management accountant of Short plc. On 1 October 1993 Short plc issued 10 million £1 preference shares at par, incurring issue costs of £100 000. The dividend payable on the preference shares was a fixed 4% per annum, payable on 30 September each year in arrears. The preference shares were redeemed on 1 October 1998 at a price of £1.35 per share. The effective finance cost of the preference shares was 10%. The balance sheet of the company on 30 September 1998, the day before the redemption of the preference shares, was as follows:

| | £ million |
|---|---|
| Ordinary share capital (non-redeemable) | 100.0 |
| Redeemable preference shares | 13.5 |
| Share premium account | 25.8 |
| Profit and loss account | 59.7 |
| | 199.0 |
| Net assets | 199.0 |

**Requirements**
(a) **Write a memorandum to your assistant which explains:**

- **how the total finance cost of the preference shares should be allocated to the profit and loss account over their period of issue;**
- **where in the profit and loss account the finance cost should be reported;**
- **where the preference shares should be disclosed in the balance sheet;**
- **the nature of any supporting information which is required to be disclosed in the notes to the financial statements regarding the preference shares.**

**Your memorandum should refer to the provisions of relevant Accounting Standards.** (8 marks)

(b) **Calculate the finance cost in respect of the preference shares for EACH of the five years ended 30 September 1998.** (7 marks)

(c) **Assuming no changes other than those caused by the redemption of the preference shares, prepare the balance sheet of Short plc at the end of 1 October 1998. You should give an explanation for any changes to any of the headings or any new headings which are required.** (5 marks)

*CIMA, Financial Reporting, November 1998* **(20 marks)**

**8.3** Your managing director has recently read an article which referred to Financial Reporting Standard 4 (FRS 4) – Capital instruments. He has requested a report from you about FRS 4.

**Requirement**

**Write a report to the managing director explaining the nature of capital instruments, giving *three* examples of capital instruments together with their required accounting treatment as specified in FRS 4.**

*CIMA, Financial Reporting, May 1995* **(20 marks)**

**8.4** Tealing plc requires advice on the appropriate accounting treatment for the following transactions in capital instruments in the year ended 30 November 2002.

(1) The company issued convertible debt on 1 December 2001 for £500 000. This will be redeemed at the same amount or converted on 30 November 2006 when the holder of the debt has the option to convert to shares. Interest payable is 5.9% for the two years ended 30 November 2003 and 14.1 % for the remaining years.

Assume that the effective rate of interest is 10.33% per annum.

(2) 250 000 5% redeemable £1 preference shares were issued on 1 June 2002. Dividends are paid annually commencing on 30 November 2002 and the shares will be redeemed at a premium of £16 600 on 30 May 2006.

Assume that the effective rate of finance cost is 6.5% per annum.

(3) A loan from the company's bankers was obtained on 1 December 2001 for £400 000. No payments are required for the first four years and the repayment terms are four annual instalments of £168 400 starting on 30 November 2005.

Assume that the effective rate of finance cost is 10.06% per annum.

**Requirements**

(a) **Calculate the amounts to be disclosed in the profit and loss account for the year ended 30 November 2002 and in the balance sheet of Tealing plc as at that date, preparing the appropriate extracts of these primary statements.** (10 marks)

(b) **Explain the appropriate accounting treatment for each of the items in (a) with appropriate reference to the Statement of Principles, noting any differences in treatment to International Accounting Standards.** (7 marks)

*ICAW, Financial Reporting, December 2002* **(17 marks)**

**8.5** Standard setters have been struggling for several years with the practical issues of the disclosure, recognition and measurement of financial instruments. The ASB has issued a Discussion Paper on Derivatives and Other Financial Instruments and Financial Reporting Standard 13 on the disclosure of such instruments. The dynamic nature of international financial markets has resulted in the widespread use of a variety of financial instruments but present accounting rules in this area do not ensure that the financial statements portray effectively the impact and risks of the instruments currently being used.

**Required**

(a) (i) **Discuss the concerns about the accounting practices used for financial instruments which led to demands for an accounting standard.** (7 marks)

(ii) **Explain why regulations dealing with disclosure alone cannot solve the problem of accounting for financial instruments.** (4 marks)

(b) (i) **Discuss three ways in which gains and losses on financial instruments might be recorded in the financial statements, commenting on the relative merits of each method.** (8 marks)

(ii) AX, a public limited company, issued a three-year £30 million 5% debenture at par on 1 December 1998 when the market rate of interest was 5%. Interest is paid annually on 30 November each year. Market rates of interest on debentures of equivalent term and risk are 6% and 4% at the end of the financial years to 30 November 1999 and 30 November 2000. (Assume that the changes in interest rates took place on 30 November each year.)

**Show the effect on 'profit' for the three years to 30 November 2001 if the debenture and the interest charge were valued on a fair value basis.** (6 marks)

*ACCA, Financial Reporting Environment (UK Stream), December 1999* **(25 marks)**

**8.6** One of the issues dealt with by the Accounting Standards Board in its *Statement of Principles for Financial Reporting* is the measurement of assets and liabilities in financial statements. The Statement notes that the historical cost system is the one most widely used in financial statements at present. However, the Statement suggests that financial reporting may well evolve towards a mixed measurement system, where some assets and liabilities are measured based on historical cost, while others are based on current values. The use of current values is already accepted practice for measuring certain categories of fixed asset, particularly properties. Recent developments appear to suggest that this practice may in future be applied to the measurement of financial instruments.

In September 1998, the ASB published FRS13 – *Derivatives and Other Financial Instruments: Disclosures.* Then, in December 2000, the ASB published a discussion paper that suggested measuring most financial instruments at current values, rather than merely providing information about current values in the notes to the financial statements. The discussion paper proposes that hedge accounting should be prohibited. Such a proposal, if implemented, would have a significant effect on current financial reporting practice in the UK. In particular, SSAP 20 – *Foreign Currency Translation* would need to be reviewed because this Accounting Standard currently permits hedge accounting in certain circumstances.

**Required**

(a) **Identify the strengths and weaknesses of using a historical cost system of measurement for assets and liabilities.** (5 marks)

(b) **Explain why a current value measurement system is more appropriate for financial instruments than a historical cost system.** (5 marks)

(c) **Explain why the disclosure requirements of FRS 13 are insufficient on their own to satisfy the needs of users.** (4 marks)

(d) **Discuss the effect of prohibiting hedge accounting on current UK accounting practice.** (6 marks)

*CIMA, Financial Reporting – UK Accounting Standards, May 2002* **(Total = 20 marks)**