CHAPTER 12

Financial instruments

12.1 Introduction

Accounting for financial instruments has proven to be one of the most difficult areas for the IASB to provide guidance on, and the current standards are far from perfect. In 2009 the IASB began a process to amend the existing financial instrument accounting with the issue of revised guidance on the recognition and measurement of financial instruments. It is expected over 2010 that new guidance on impairment, hedging and derecognition of assets and liabilities will also be issued. The new guidance is unlikely to be mandatory until 2013. In this chapter we will consider the main requirements of IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosure* as well as the main changes introduced by the revised standard, IFRS 9 *Financial Instruments* and the likely changes in accounting for impairment of financial assets.

Objectives

By the end of this chapter, you should be able to:

- define what financial instruments are and be able to outline the main accounting requirements under IFRS;
- comment critically on the international accounting requirements for financial instruments and understand why they continue to prove both difficult and controversial topics in accounting;
- account for different types of common financial instrument that companies may use.

12.2 Financial instruments – the IASB's problem child

International accounting has had standards on financial instruments since the late 1990s and, ever since they were introduced, they have proved the most controversial requirements of IFRS. In the late 1990s, in order to make international accounting standards generally acceptable to stock exchanges, the International Accounting Standards Committee (forerunner of the International Accounting Standards Board) introduced IAS 32 and 39. These standards drew heavily on US GAAP as that was the only comprehensive regime that had guidance in this area. Even now some national accounting standards, such as the UK regime, do not have compulsory comprehensive accounting standards on financial instruments for all companies.

Ever since their issue the guidance on financial instruments has been criticised by users, preparers, auditors and others and has also been the only area of accounting that has caused real political problems. As this text is being written in early 2010 the IASB is being put

under pressure from the G20 nations and the European Union to look at its guidance and it has committed to revise the standards by the end of 2010.

12.2.1 Rules versus principles

IAS 32 and 39 are sourced from US GAAP (although not fully consistent with US GAAP) and this has led to one of the first major criticisms of the guidance, that it is too 'rules' based. The international accounting standards aim to be a principles based accounting regime where the accounting standards establish good principles that underpin the accounting treatments but not every possible situation or transaction is covered in guidance. Generally US GAAP, whilst still having underpinning principles, tends to have a significantly greater number of 'rules' and as a result IAS 32 and 39 have significant and detailed rules within them.

The difficulty with the rules based approach is that some companies claim that they cannot produce financial statements that reflect the intent behind their transactions. For example, an area we will be considering in this chapter is hedge accounting. Some companies have claimed that the very strict hedge accounting requirements in IAS 39 are so difficult to comply with that they cannot reflect what they consider are genuine hedge transactions appropriately in their financial statements. The extract below is from the 2007 Annual Report of Rolls Royce and shows that there can be a significant difference between reported earnings under IFRS and the 'underlying' performance of the business:

> On the basis described below, underlying profit before tax was £800 million (2006 £705 million). The adjustments are detailed in note 2 on page 77.
>
> The published profit before tax reduced to £733 million from £1,391 million in 2006. This is primarily due to reduced benefits from the unrealised fair value derivative contracts, lower benefit from foreign exchange hedge reserve release and finally the recognition of past service costs for UK pension schemes, all of which are excluded from the calculation of underlying performance.
>
> The Group is exposed to fluctuations in foreign currency exchange rates and commodity price movements. These exposures are mitigated through the use of currency and commodity derivatives for which the Group does not apply hedge accounting.
>
> As a result, reported earnings do not reflect the economic substance of derivatives that have been closed out in the financial year, but do include unrealised gains and losses on derivatives which will only affect cash flows when they are closed out at some point in the future.
>
> Underlying earnings are presented on a basis that shows the economic substance of the Group's hedging strategies in respect of transactional exchange rate and commodity price movements. Further information is included within key performance indicators on page 20 of this report.

12.2.2 The 2008 financial crisis

The financial crisis that began in 2008 highlighted problems with IAS 39 and caused more political intervention in accounting standard setting than had previously been seen. Also the IASB were forced into a position where it had to change an accounting standard without any due process, an action which the IASB felt was necessary but that has drawn widespread criticism.

As you read the chapter you will appreciate that IAS 39 requires different measurement bases for different types of financial assets and liabilities. How a company determines which measurement to use, broadly the choice being fair value or amortised cost, depends on how instruments are classified, there being four different asset classifications allowed by IAS 39. Many banks in the financial crisis were caught in a position where they had loan

assets measured at fair value, and the fair value of those loans was reducing significantly, with the potential for major losses.

Banks will keep their loan assets generally in two books, a 'trading' book where the loans are measured at fair value through profit or loss, and a 'banking' book where the loans are measured at amortised cost. Up to October 2008 under IAS 39 if a company chose to measure its financial assets or liabilities at fair value through profit or loss it was not allowed to subsequently reclassify those loans and start measuring them at amortised cost. Many banks had included loans in the 'trading' book which, because of illiquidity in financial markets they could not sell, and for which the market values significantly reduced. The losses on revaluation were all going to be charged against their profit and this was causing some concern.

The issue came to a head when the European Union, through work carried out by the French, identified that under US GAAP reclassification was allowed and therefore European banks were potentially in a worse position than their American counterparts. The European Union concluded that this was unacceptable and that if IAS 39 was not altered they would 'carve out' the section of IAS 39 restricting the transfer and not make that part of the standards relevant to EU businesses. This was perceived as a major threat by the IASB, in particular to its convergence work with US GAAP, and therefore the IASB amended IAS 39 to allow reclassification. For the first time ever an amendment was made that had not been issued as a discussion paper or exposure draft, it was simply a change to the standard. This has led to significant criticism of the IASB and calls for its due process to be revisited to ensure this does not happen again.

The political interest in accounting has continued with global politicians putting pressure on the IASB to speed up its work on certain areas. In addition it has led to calls for the IASB to examine the way it operates and its governance: a number of governments are concerned that a board, on which they have no representation, can set accounting standards which have to be followed by companies in their country. To highlight how high these issues have been on the agenda of politicians the following are extracts from the G20 communiqué issued after the meeting on 15 November 2008:

> **Strengthening Transparency and Accountability**
> ***Immediate Actions by March 31, 2009.***
> The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
>
> Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off balance sheet vehicles.
>
> Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
>
> With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
>
> **Promoting Integrity in Financial Markets Immediate Actions by March 31, 2009.**
> ***Medium-term actions***
> The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
>
> Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.

It is likely that 2010 will see further changes in the accounting standards in response to the financial crisis, not only for measurement of financial instruments that was addressed by IFRS 9 but also in areas such as consolidation, derecognition of financial assets, impairment and structured entities and securitisation.

12.3 IAS 32 *Financial Instruments: Disclosure and Presentation*[1]

The dynamic nature of the international financial markets has resulted in a great variety of financial instruments from traditional equity and debt instruments to derivative instruments such as futures or swaps. These instruments are a mixture of on and off balance sheet instruments, and they can significantly contribute to the risks that an enterprise faces. IAS 32 was introduced to highlight to users of financial statements the range of financial instruments used by an enterprise and how they affect the financial position, performance and cash flows of the enterprise.

IAS 32 only considers the areas of presentation of financial instruments; recognition and measurement are considered in a subsequent standard, IAS 39.

12.3.1 Scope of the standard

IAS 32 should be applied by all enterprises and should consider all financial instruments with the exceptions of:

(a) share-based payments as defined in IFRS 2;

(b) interests in subsidiaries as defined in IAS 27;

(c) interests in associates as defined in IAS 28;

(d) interests in joint ventures as defined in IAS 31;

(e) employers' rights and ligations under employee benefit plans;

(f) rights and obligations arising under insurance contracts (except embedded derivatives requiring separate accounting under IAS 39).

12.3.2 Definition of terms[2]

The following definitions are used in IAS 32 and also in IAS 39, which is to be considered later.

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

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

(a) cash;

(b) a contractual right to receive cash or another financial asset from another entity;

(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.

Following the introduction of IAS 39 extra clarification was introduced into IAS 32 in the application of the definitions. First, a commodity-based contract (such as a commodity future) is a financial instrument if either party can settle in cash or some other financial instrument. Commodity contracts would not be financial instruments if they were expected to be settled by delivery, and this was always intended.

The second clarification is for the situation where an enterprise has a financial liability that can be settled either with financial assets or the enterprise's own equity shares. If the number of equity shares to be issued is variable, typically so that the enterprise always has an obligation to give shares equal to the fair value of the obligation, they are treated as a financial liability.

12.3.3 Presentation of instruments in the financial statements

Two main issues are addressed in the standard regarding the presentation of financial instruments. These issues are whether instruments should be classified as liabilities or equity instruments, and how compound instruments should be presented.

Liabilities v equity

IAS 32 follows a substance approach[3] to the classification of instruments as liabilities or equity. If an instrument has terms such that there is an obligation on the enterprise to transfer financial assets to redeem the obligation then it is a liability instrument regardless of its legal nature. Preference shares are the main instrument where in substance they could be liabilities but legally are equity. The common conditions on the preference share that would indicate it is to be treated as a liability instrument are as follows:

- annual dividends are compulsory and not at the discretion of directors; or
- the share provides for mandatory redemption by the issuer at a fixed or determinable amount at a future fixed or determinable date; or
- the share gives the holder the option to redeem upon the occurrence of a future event that is highly likely to occur (e.g. after the passing of a future date).

If a preference share is treated as a liability instrument, it is presented as such in the statement of financial position and also any dividends paid or payable on that share are calculated in the same way as interest and presented as a finance cost in the statement of comprehensive income. The presentation on the statement of comprehensive income could be as a separate item from other interest costs but this is not mandatory. Any gains or losses on the redemption of financial instruments classified as liabilities are also presented in profit or loss.

Impact on companies

The presentation of preference shares as liabilities does not alter the cash flows or risks that the instruments give, but there is a danger that the perception of a company may change. This presentational change has the impact of reducing net assets and increasing gearing. This could be very important, for example, if a company had debt covenants on other borrowings that required the maintenance of certain ratios such as gearing or interest cover. Moving preference shares to debt and dividends to interest costs could mean the covenants are breached and other loans become repayable.

In addition, the higher gearing and reduced net assets could mean the company is perceived as more risky, and therefore a higher credit risk. This in turn might lead to a

reduction in the company's credit rating, making obtaining future credit more difficult and expensive.

These very practical issues need to be managed by companies converting to IFRS from a local accounting regime that treats preference shares as equity or non-equity funds. Good communication with users is key to smoothing the transition.

Compound instruments[4]

Compound instruments are financial instruments that have the characteristics of both debt and equity. A convertible loan, which gives the holder the option to convert into equity shares at some future date, is the most common example of a compound instrument. The view of the IASB is that the proceeds received by a company for these instruments are made up of two parts, a debt obligation and an equity option, and following the substance of the instruments IAS 32 requires that the two parts be presented separately, a 'split accounting' approach.

The split is made by measuring the debt part and making the equity the residual of the proceeds. This approach is in line with the definitions of liabilities and equity, where equity is treated as a residual. The debt is calculated by discounting the cash flows on the debt at a market rate of interest for similar debt without the conversion option.

The following is an extract from the 2007 Balfour Beatty Annual Return relating to convertible preference shares:

> The Company's cumulative convertible redeemable preference shares are regarded as a compound instrument, consisting of a liability component and an equity component. The fair value of the liability component at the date of issue was estimated using the prevailing market interest rate for a similar non-convertible instrument. The difference between the proceeds of issue of the preference shares and the fair value assigned to the liability component, representing the embedded option to convert the liability into the Company's ordinary shares, is included in equity.
>
> The interest expense on the liability component is calculated by applying the market interest rate for similar non-convertible debt prevailing at the date of issue to the liability component of the instrument. The difference between this amount and the dividend paid is added to the carrying amount of the liability component and is included in finance charges, together with the dividend payable, in the statement of comprehensive income.

Illustration for compound instruments

Rohan plc issues 1,000 £100 5% convertible debentures at par on 1 January 2000. The debentures can either be converted into 50 ordinary shares per £100 of debentures, or redeemed at par at any date from 1 January 2005. Interest is paid annually in arrears on 31 December. The interest rate on similar debentures without the conversion option is 6%.

To split the proceeds the debt value must be calculated by discounting the future cash flows on the debt instrument.

The value of debt is therefore:

Present value of redemption payment (discounted @ 6%)	£74,726
Present value of interest (5 years) (discounted @ 6%)	£21,062
Value of debt	£95,788
Value of the equity proceeds: (£100,000 – £95,788) (presented as part of equity)	£4,212

The extract below from Balfour Beatty shows the impact of compound instruments when spilt accounting was adopted in 2004:

Extract from Balfour Beatty IFRS restatement of 2004 results
Preference shares:
The Group's £136m outstanding convertible redeemable preference shares included within 'Shareholders' funds' at 31 December 2004 under UK GAAP are, under IAS 32, regarded as a compound instrument consisting of a liability (£112m, including £10m deferred tax) and an equity component (£19m). The preference dividend is shown in the statement of comprehensive income as an interest expense.

	UK GAAP	*IAS 32 Adjusted*
Capital and reserves		
Called-up share capital	213	212
Share premium account	150	15
Equity component of preference shares	—	19
Non-current liabilities		
Liability component of preference shares	—	(102)

Perpetual debt

Following a substance approach, perpetual or irredeemable debt could be argued to be an equity instrument as opposed to a debt instrument. IAS 32, however, takes the view that it is a debt instrument because the interest must be paid (as compared to dividends which are only paid if profits are available for distribution and if directors declare a dividend approved by the shareholders), and the present value of all the future obligations to pay interest will equal the proceeds of the debt if discounted at a market rate. The proceeds on issue of a perpetual debt instrument are therefore a liability obligation.

12.3.4 Calculation of finance costs on liability instruments

The finance costs will be changed to profit or loss. The finance cost of debt is the total payments to be incurred over the life-span of that debt less the initial carrying value. Such costs should be allocated to profit or loss over the life-time of the debt at a constant rate of interest based on the outstanding carrying value per period. If a debt is settled before maturity, any profit or loss should be reflected immediately in profit or loss – unless the substance of the settlement transaction fails to generate any change in liabilities and assets.

Illustration of the allocation of finance costs and the determination of carrying value

On 1 January 20X6 a company issued a debt instrument of £1,000,000 spanning a four-year term. It received from the lender £890,000, being the face value of the debt less a discount of £110,000. Interest was payable yearly in arrears at 8% per annum on the principal sum of £1,000,000. The principal sum was to be repaid on 31 December 20X9.

To determine the yearly finance costs and year-end carrying value it is necessary to compute:

- the aggregate finance cost;
- the implicit rate of interest carried by the instrument (also referred to as the effective yield);
- the finance charge per annum; and
- the carrying value at successive year-ends.

Aggregate finance cost
This is the difference between the total future payments of interest plus principal, less the net proceeds received less costs of the issue, i.e. £430,000 in column (i) of Figure 12.1.

Figure 12.1 Allocation of finance costs and determination of carrying value

	(i) *Cash flows* £000		*(ii)* *Finance charge to Statement of comprehensive income* £000		*(iii)* *Carrying value in balance sheet* £000
At 1 Jan 20X6	(890)	(1,000 – 110)	—		890
At 31 Dec 20X6	80	(8% × 1,000)	103.2	(11.59% × 890)	913.2
At 31 Dec 20X7	80	(8% × 1,000)	105.8	(11.59% × 913.2)	939.2
At 31 Dec 20X8	80	(8% × 1,000)	108.8	(11.59% × 939)	967.8
At 31 Dec 20X9	1,080	(1,000 + (8% × 1,000))	112.2	(11.59% × 967.8)	—
Net cash flow	430	= Cost	430		

Implicit rate of interest carried by the instrument

This can be computed by using the net present value (NPV) formula:

$$\sum^{t=n} \frac{At}{1+r} - I = 0$$

where A is forecast net cash flow in year A, t time (in years), n the life-span of the debt in years, r the company's annual rate of discount and I the initial net proceeds. Note that the application of this formula can be quite time-consuming. A reasonable method of assessment is by interpolation of the interest rate.

The aggregate formula given above may be disaggregated for calculation purposes:

$$\sum_{t=1}^{t=n} \frac{A1}{(1+r)} + \frac{A2}{(1+r)^2} + \frac{A3}{(1+r)^3} + \frac{A4}{(1+r)^4} - I = 0$$

Using the data concerning the debt and assuming (allowing for discount and costs) an implicit constant rate of, say, 11%:

$$\Sigma = \frac{80{,}000}{(1.11)^1} + \frac{80{,}000}{(1.11)^2} + \frac{80{,}000}{(1.11)^3} + \frac{1{,}080{,}000}{(1.11)^4} - 890{,}000 = 0$$

$$= 72{,}072 + 64{,}930 + 58{,}495 + 711{,}429 - 890{,}000 = +16{,}926$$

The chosen implicit rate of 11% is too low. We now choose a higher rate, say 12%:

$$\Sigma = \frac{80{,}000}{(1.12)^1} + \frac{80{,}000}{(1.12)^2} + \frac{80{,}000}{(1.12)^3} + \frac{1{,}080{,}000}{(1.12)^4} - 890{,}000 = 0$$

$$= 71{,}429 + 63{,}776 + 56{,}942 + 686{,}360 - 890{,}000 = -11{,}493$$

This rate is too high, resulting in a negative net present value. Interpolation will enable us to arrive at an implicit rate:

$$11\% + \left[\frac{16{,}926}{16{,}926 + 11{,}493} \times (12\% - 11\%) \right]$$

$$= 11\% + 0.59\% = 11.59\%$$

This is a trial and error method of determining the implicit interest rate. In this example the choice of rates, 11% and 12%, constituted a change of only 1%. It would be possible to choose, say, 11% and then 14%, generating a 3% gap within which to interpolate. This wider margin would result in a less accurate implicit rate and an aggregate interest charge at variance with the desired £430,000 of column (ii). The aim is to choose interest rates as close as possible to either side of the monetary zero, so that the exact implicit rate may be computed.

The object is to determine an NPV of zero monetary units, i.e. to identify the discount rate that will enable the aggregate future discounted net flows to equate to the initial net proceeds from the debt instrument. In the above illustration, a discount (interest) rate of 11.59% enables £430,000 to be charged to profit or loss after allowing for payment of all interest, costs and repayment of the face value of the instrument.

The finance charge per annum and the successive year-end carrying amounts

The charge to the statement of comprehensive income and the carrying values in the statement of financial position are shown in Figure 12.1.

12.3.5 Offsetting financial instruments[5]

Financial assets and liabilities can only be offset and presented net if the following conditions are met:

(a) the enterprise has a legally enforceable right to set off the recognised amounts; and

(b) the enterprise intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

IAS 32 emphasises the importance of the intention to settle on a net basis as well as the legal right to do so. Offsetting should only occur when the cash flows and therefore the risks associated with the financial asset and liability are offset and therefore to present them net in the statement of financial position shows a true and fair view.

Situations where offsetting would not normally be appropriate are:

- several different financial instruments are used to emulate the features of a single financial instrument;
- financial assets and financial liabilities arise from financial instruments having the same primary risk exposure but involve different counterparties;
- financial or other assets are pledged as collateral for non-recourse financial liabilities;
- financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation;
- obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance policy.

12.4 IAS 39 *Financial Instruments: Recognition and Measurement*

IAS 39 is the first comprehensive standard on the recognition and measurement of financial instruments and completes the guidance that was started with the introduction of IAS 32.

12.4.1 Scope of the standard

IAS 39 should be applied by all enterprises to all financial instruments except those excluded from the scope of IAS 32 (see above) and the following additional instruments:

- rights and obligations under leases to which IAS 17 applies (except for embedded derivatives);
- equity instruments of the reporting entity including options, warrants and other financial instruments that are classified as shareholders' equity;
- contracts between an acquirer and a vendor in a business combination to buy or sell or acquire at a futue date;
- rights to payments to reimburse the entity for expenditure it is required to make to settle a liability under IAS 37.

12.4.2 Definitions of four categories of financial instruments

The four categories are (a) financial assets or liabilities at fair values through profit or loss, (b) held-to-maturity investments, (c) loans and receivables, and (d) available-for-sale financial assets. The definition of each is as stated below.

(a) Financial assets or liabilities at fair values through profit or loss

Assets and liabilities under this category are reported in the financial statements at fair value. Changes in the fair value from period to period are reported as a component of net income. There are two types of investments that are accounted for under this heading, namely, *held-for trading investments* and *designated on initial recognition*.

Held-for-trading investments

These are financial instruments where (i) the investor's principal intention is to sell or repurchase a security in the near future and where there is normally active trading for profit-taking in the securities, or (ii) they are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking, or (iii) they are derivatives. This category includes commercial papers, certain government bonds and treasury bills.

A **derivative** is a financial instrument:

- whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable (sometimes called the 'underlying');
- that requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors; and
- that is settled at a future date.

Designated on initial recognition

A company has the choice of designating as fair value through profit or loss on the initial recognition of an investment in the following situations:

- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

- a group of financial assets, financial liabilities or both is managed and performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; or
- the financial asset or liability contains an embedded derivative that would otherwise require separation from the host.

The following is an extract from the Fortis Consolidated Financial Statements 2007 Annual Report:

> Financial assets at fair value through profit or loss include:
>
> **(i)** financial assets held for trading, including derivative instruments that do not qualify for hedge accounting
>
> **(ii)** financial assets that Fortis has irrevocably designated at initial recognition or first-time adoption of IFRS as held at fair value through profit or loss, because:
>
> – the host contract includes an embedded derivative that would otherwise require separation
>
> – it eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch')
>
> – it relates to a portfolio of financial assets and/or liabilities that are managed and evaluated on a fair value basis.

Prior to October 2008 it was prohibited to transfer instruments either into or out of the fair value through profit or loss category after initial recognition of the instrument. Following significant pressure that the international standards were more restrictive than US GAAP in this area, the IASB amended the standard to allow reclassification of financial instruments in rare circumstances. The financial crisis of 2008 was deemed to be a rare situation that would justify reclassification.

The reclassification requirements allow instruments to be transferred from fair value through profit and loss to the loans and receivables category. They also allow reclassifications from the available for sale category (discussed later) to the loans and receivables category. The IASB allowed a short-term exemption from the general requirement that the transfer is at fair value, and permitted the transfers to be undertaken at the fair values of instruments on 1 July 2008, a date before significant reductions in fair value on debt instruments arose.

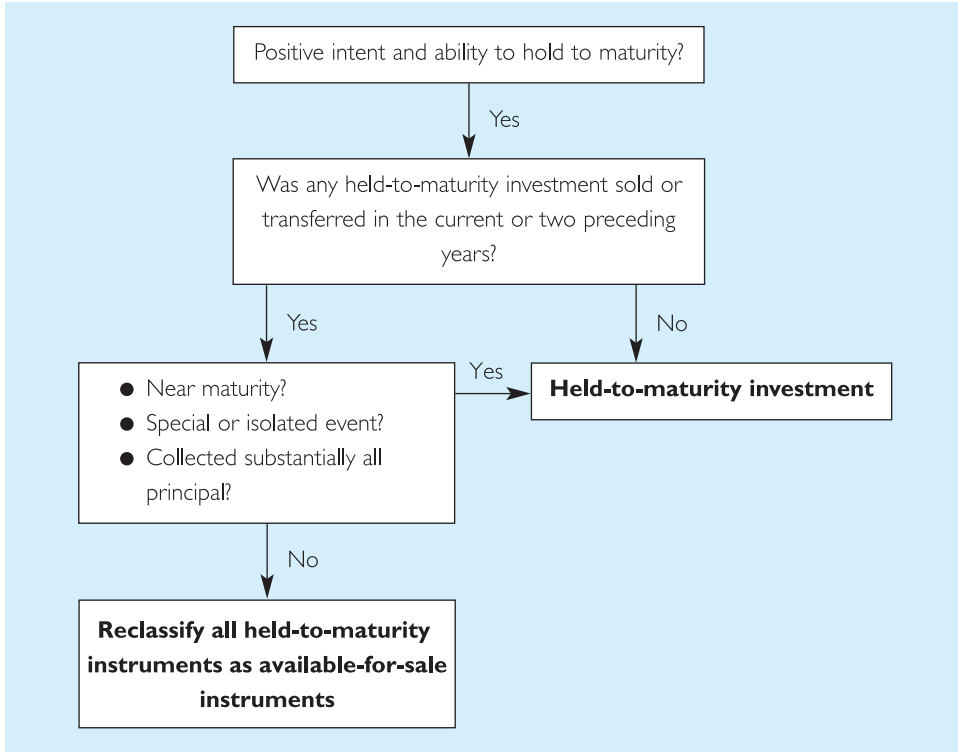
(b) Held-to-maturity investments

Held-to-maturity investments consist of instruments with fixed or determinable payments and fixed maturity for which the entity positively intends and has the ability to hold to maturity. For items to be classified as held-to-maturity an entity must justify that it will hold them to maturity. The tests that a company must pass to justify this classification are summarised in Figure 12.2.

The investments are initially measured at fair value (including transaction costs) and subsequently measured at amortised cost using the effective interest method, with the periodic amortisation recorded in the statement of comprehensive income. As they are reported at amortised cost, temporary fluctuations in fair value are not reflected in the entity's financial statements.

Such investments include corporate and government bonds and redeemable preference shares which can be held to maturity. It does not include investments that are those designated as at fair value through profit or loss on initial recognition, those designated as available for sale and those defined as loans and receivables. It also does not include ordinary shares in other entities because these do not have a maturity date.

Figure 12.2 Tests for classification as held-to-maturity investment



(c) Loans and receivables

Loans and receivables include financial assets with fixed or determinable payments that are not quoted in an active market. They are initially measured at fair value (including transaction costs) and subsequently measured at amortised cost using the effective interest method, with the periodic amortisation in the statement of comprehensive income.

Amortised cost is normally the amount at which a financial asset or liability is measured at initial recognition minus principal repayments, minus the cumulative amortisation of any premium and minus any write-down for impairment.

This category includes trade receivables, accrued revenues for services and goods, loan receivables, bank deposits and cash at hand. It does not include financial assets held for trading, those designated on initial recognition as at fair value through profit or loss, those available-for-sale and those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

(d) Available-for-sale financial assets

A common financial asset that would be classified as available-for-sale would be equity investments in another entity.

On initial recognition an asset is reported at cost and at period-ends it is restated to fair value with changes in fair value reported under *Other comprehensive income*. If the fair value falls below amortised cost and the fall is not estimated to be temporary, it is reported in the investor's statement of comprehensive income.

The fair value of publicly traded securities is normally based on quoted market prices at the year-end date. The fair value of securities that are not publicly traded is assessed using

a variety of methods and assumptions based on market conditions existing at each year-end date referring to quoted market prices for similar or identical securities if available or employing other techniques such as option pricing models and estimated discounted values of future cash flows.

Available-for-sale does not include debt and equity securities classified as held for trading or held-to-maturity.

Example of accounting for an available-for-sale financial asset: the acquisition by Brighton plc of shares in Hove plc

On 1 September 20X9 Brighton purchased 15 million of the 100 million shares in Hove for £1.50 per share. This purchase was made with a view to further purchases in future. The Brighton directors are not able to exercise any influence over the operating and financial policies of Hove. The shares are currently in the Statement of Financial Position as at 31 December 20X9 at cost and the fair value of a share was £1.70.

Accounting treatment at the year end

Brighton owns 15% of the Hove issued shares. As the directors are not able to exercise any influence, the investment is dealt with under IAS 39 *Financial Instruments: Measurement Recognition* and under its provisions the investment is an available for sale financial asset. This means that it is to be valued at fair value, with gains or losses taken to equity.

In this case the investment is valued at £25.5 million (15 million × £1.70) and the gain of £3 million (15 million × (£1.70 – £1.50)) is taken to equity through other comprehensive income.

Headings under which reported

Assets are reported as appropriate in the Statement of position under Other non-current assets, Trade and Other Receivables, Interest-bearing Receivables, Cash and Cash Equivalents. Financial liabilities measured at amortised cost comprises financial liabilities, such as borrowings, trade payables, accrued expenses for services and goods, and certain provisions settled in cash and are reported in the position statement under Long-term and Short-term Borrowings, Other Provisions, Other Long-term Liabilities, Trade Payables and Other Current Liabilities.

Impact of classification on the financial statements

The impact of the classification of financial instruments on the financial statements is important as it affects the value of assets and liabilities and also the income recognised. For example, assume that Henry plc had the following financial assets and liabilities at its year-end. All the instruments had been taken out at the start of the current year:

1 A forward exchange contract. At the period-end date the contract was an asset with a fair value of £100,000.
2 An investment of £1,000,000 in a 6% corporate bond. At the period-end date the market rate of interest increased and the bond fair value fell to £960,000.
3 An equity investment of £500,000. This investment was worth £550,000 at the period-end.

The classification of these instruments is important and choices are available as to how they are accounted for. For example, the investment in the corporate bond above could be accounted for as a held-to-maturity investment if Henry plc had the intent and ability to hold it to maturity, or it could be an available-for-sale investment if so chosen by Henry. The bond and the equity investment could even be recognised as fair value through profit or loss if they met the criteria to be designated as such on initial recognition.

To highlight the impact on the financial statements, the tables below show the accounting positions for the investments on different assumptions. Not all possible classifications are shown in the tables:

Option 1

Instrument	*Classification*	*Statement of financial position*	*Profit or loss*	*Other comprehensive income*
Forward contract	FV-P&L	£100,000	£100,000	—
Corporate bond	Held-to-maturity	£1,000,000	*(£60,000)	—
Equity investment	Available-for-sale	£550,000	—	£50,000

* *Interest on the bond of £1,000,000 × 6%*

The bond is not revalued because held-to-maturity investments are recognised at amortised cost.

Option 2

Instrument	*Classification*	*Statement of financial position*	*Profit or loss*	*Other comprehensive income*
Forward contract	FV-P&L	£100,000	£100,000	—
Corporate bond	Available-for-sale	£960,000	(£60,000)	(£40,000)
Equity investment	Available-for-sale	£550,000	—	£50,000

Interest is still recognised on the bond but at the year-end it is revalued through equity to its fair value of £960,000.

Option 3

Instrument	*Classification*	*Statement of financial position*	*Profit or loss*	*Other comprehensive income*
Forward contract	FV-P&L	£100,000	£100,000	—
Corporate bond	Held-to-maturity	£1,000,000	(£60,000)	—
Equity investment	FV-P&L	£550,000	£50,000	—

The equity investment is revalued through profit and loss as opposed to through other comprehensive income as it would be if classified as available-for-sale.

12.4.3 Recognition of financial instruments

Initial recognition

A financial asset or liability should be recognised when an entity becomes party to the contractual provisions of the instrument. This means that derivative instruments must be recognised if a contractual right or obligation exists.

Derecognition

Financial assets should only be derecognised when the entity transfers the risks and rewards that comprise the asset. This could be because the benefits are realised, the rights expire or the enterprise surrenders the benefits.

If it is not clear whether the risks and reward have been transferred, the entity considers whether control has passed. If control has passed, the entity should derecognise the asset; whereas if control is retained, the asset is recognised to the extent of the entity's continuing involvement in the asset.

On derecognition any gain or loss should be recorded in profit or loss. Also any gains or losses previously recognised in reserves relating to the asset should be transferred to the profit or loss on sale.

Financial liabilities should only be derecognised when the obligation specified in the contract is discharged, cancelled or expires.

The rule on the derecognition of liabilities does mean that it is not acceptable to write off liabilities. In some industries this will lead to a change in business practice. For example, UK banks are not allowed to remove dormant accounts from their statements of financial position as the liability has not been legally extinguished.

12.4.4 Embedded derivatives

Sometimes an entity will enter into a contract that includes both a derivative and a host contract – with the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative. Examples of such embedded derivatives could be a put option on an equity instrument held by an enterprise, or an equity conversion feature embedded in a debt instrument.

An embedded instrument should be separated from the host contract and accounted for as a derivative under IAS 39 if all of the following conditions are met:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid instrument is not measured at fair value with changes in fair value reported in profit or loss.

If an entity is required to separate the embedded derivative from its host contract but is unable to separately measure the embedded derivative, the entire hybrid instrument should be treated as a financial instrument held at fair value through profit or loss and as a result changes in fair value should be reported through profit or loss.

12.4.5 Measurement of financial instruments

Initial measurement

Financial assets and liabilities (other than those at fair value through profit or loss) should be initially measured at fair value plus transaction costs. In almost all cases this would be at cost. For instruments at fair value through profit and loss, transaction costs are not included.

Subsequent measurement

Figure 12.3 summarises the way that financial assets and liabilities are to be subsequently measured after initial recognition.

The measurement after initial recognition is at either fair value or amortised cost. The only financial instruments that can be recognised at cost (not amortised) are equity investments for which there is no measurable fair value. These should be very rare.

The fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction.

The methods for fair value measurement allow a number of different bases to be used for the assessment of fair value. These include:

Figure 12.3 Subsequent measurement

Category	*Measurement*
Financial assets at fair value through profit or loss*	Fair value without any deduction for transaction costs on sale or disposal.
Held-to-maturity investments	Amortised cost using the effective interest method
Loans and receivables	Amortised cost using the effective interest method
Available-for-sale financial assets*	Fair value without any deduction for transaction costs on sale or disposal
Financial liabilities at fair value through profit or loss	Fair value
Other financial liabilities	Amortised cost using the effective interest method

* If these categories include unquoted equity instruments (or derivative liabilities that are settled in unquoted equity instruments) where fair value cannot be measured reliably then they are measured at cost. This however should be very rare.

- published market prices;
- transactions in similar instruments;
- discounted future cash flows;
- valuation models.

The method used will be the one which is most reliable for the particular instrument.

In the 2008 financial crisis there were calls on the IASB to either abolish or suspend the fair value measurement basis in IAS 39 as it has been perceived as requiring companies to recognise losses greater than their true value. The reason for this is that some claim the market value is being distorted by a lack of liquidity in the markets and that markets are not functioning efficiently with willing buyers and sellers. The IASB has resisted the calls but has issued guidance on valuation in illiquid markets that emphasises the different ways that fair value can be determined. For instruments that operate in illiquid markets there is sometimes a need to value the instruments based on valuation models and discounted cash flows, however these models take into account factors that a market participant would consider in the current circumstances.

Amortised cost is calculated using the effective interest method on assets and liabilities. For the definition of effective interest it is necessary to look at IAS 39, para. 9. The effective rate is defined as:

> 'the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument'.
>
> The definition then goes on to require that the entity shall:

- estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options), but not future credit losses;

- include all necessary fees and points paid or received that are an integral part of the effective yield calculation (IAS 18);
- make a presumption that the cash flows and expected life of a group of similar financial instruments can be estimated reliably.

Illustration of the effective yield method

George plc lends £10,000 to a customer for fixed interest based on the customer paying 5% interest per annum (annually in arrears) for 2 years, and then 6% fixed for the remaining 3 years with the full £10,000 repayable at the end of the 5-year term.

The tables below show the interest income over the loan period assuming:

(a) it is not expected that the customer will repay early (effective rate is 5.55% per annum derived from an internal rate of return calculation); and

(b) it is expected the customer will repay at the end of year 3 but there are no repayment penalties (effective rate is 5.3% per annum derived from an internal rate of return calculation).

The loan balance will alter as follows:

No early repayment

Period	*B/F*	*Interest income (5.55%)*	*Cash received*	*C/F*
Year 1	10,000	555	(500)	10,055
Year 2	10,055	558	(500)	10,113
Year 3	10,113	561	(600)	10,074
Year 4	10,074	559	(600)	10,033
Year 5	10,033	557	(10,600)	(10)*

* Difference due to rounding

Early repayment

Period	*B/F*	*Interest income (5.3%)*	*Cash received*	*C/F*
Year 1	10,000	530	(500)	10,030
Year 2	10,030	532	(500)	10,062
Year 3	10,062	533	(10,600)	(5)*

* Difference due to rounding

Gains or losses on subsequent measurement

When financial instruments are remeasured to fair value the rules for the treatment of the subsequent gain or loss are as shown in Figure 12.4. Gains or losses arising on financial

Figure 12.4 Gains or losses on subsequent measurements

Instrument	*Gain or loss*
Instruments at fair value through profit or loss	Profit or loss
Available-for-sale	Equity (except for impairments and foreign exchange gains and losses) until derecognition, at which time the cumulative gain/loss in equity is recognised in profit or loss. Dividend income is recognised in profit or loss when the right to receive payment is established.

instruments that have not been remeasured to fair value will arise either when the assets are impaired or the instruments are derecognised. These gains and losses are recognised in profit or loss for the period.

12.4.6 Hedging

If a financial instrument has been taken out to act as a hedge, and this position is clearly identified and expected to be effective, hedge accounting rules should be followed.

There are three types of hedging relationship:

1 Fair value hedge

A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment that will affect reported net income. Any gain or loss arising on remeasuring the hedging instrument and the hedged item should be recognised in profit or loss in the period.

2 Cash flow hedge

A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with the recognised asset or liability and that will affect reported net income. A hedge of foreign exchange risk on a firm commitment may be a cash flow or a fair value hedge. The gain or loss on the hedging instrument should be recognised directly in other comprehensive income. Any gains or losses recognised in other comprehensive income should be included in profit or loss in the period that the hedged item affects profit or loss. If the instrument being hedged results in the recognition of a non-financial asset or liability, the gain or loss on the hedging instrument can be recognised as part of the cost of the hedged item.

Cash flow hedge illustrated

Harvey plc directors agreed at their July 2006 meeting to acquire additional specialist computer equipment in September 2007 at an estimated cost of $500,000.

The company entered into a forward contract in July 2006 to purchase $500,000 in September 2007 and pay GBP260,000. At the year-end in December 2006 the $ has appreciated and has a sterling value of GBP276,000.

At the year-end the increase of GBP16,000 will be debited to Forward Contract and credited to a hedge reserve.

In September 2007 when the equipment is purchased the 16,000 will be deducted in its entirety from the Equipment carrying amount or transferred as a reduction of the annual depreciation charge.

3 Net investment hedge

A hedge of an investment in a foreign entity. The gain or loss on the hedging instrument should be recognised directly in other comprehensive income to match against the gain or loss on the hedged investment.

Conditions for hedge accounting

In order to be able to apply the hedge accounting techniques detailed above, an entity must meet a number of conditions. These conditions are designed to ensure that only genuine hedging instruments can be hedge accounted, and that the hedged positions are clearly identified and documented.

The conditions are:

- at the inception of the hedge there is formal documentation of the hedge relationship and the enterprise's risk management objective and strategy for undertaking the hedge;
- the hedge is expected to be highly effective at inception and on an ongoing basis in achieving offsetting changes in fair values or cash flows;
- the effectiveness of the hedge can be reliably measured, that is the fair value of the hedged item and the hedging instrument can be measured reliably;
- for cash flow hedges, a forecasted transaction that is the subject of the hedge must be highly probable; and
- the hedge was assessed on an ongoing basis and determined actually to have been effective throughout the accounting period (effective between 80% and 125%).

12.5 IFRS 7 *Financial Statement Disclosures*[6]

12.5.1 Introduction

This standard came out of the ongoing project of improvements to the accounting and disclosure requirements relating to financial instruments.

For periods before those starting on or after 1 January 2007 disclosures in respect of financial instruments were governed by two standards:

1 IAS 30 *Disclosures in the financial statements of banks and similar financial institutions*; and

2 IAS 32 *Financial instruments: disclosure and presentation*.

In drafting IFRS 7, the IASB:

- reviewed existing disclosures in the two standards, and removed duplicative disclosures;
- simplified the disclosure about concentrations of risk, credit risk, liquidity risk and market risk under IAS 32; and
- transferred disclosure requirements from IAS 32.

12.5.2 Main requirements

The standard applies to all entities, regardless of the quantity of financial instruments held. However, the extent of the disclosures required will depend on the extent of the entity's use of financial instruments and of its exposure to risk.

The standard requires disclosure of:

- the significance of financial instruments for the entity's financial position and performance (many of these disclosures were previously in IAS 32); and
- qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk, and market risk.

The qualitative disclosures describe management's objectives, policies and processes for managing those risks.

The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on the information provided internally to the entity's key management personnel.

For the disclosure of the significance of financial instruments for the entity's financial position and performance a key aspect will be to clearly link the statement of financial position and the statement of comprehensive income to the classifications in IAS 39. The requirements from IFRS in this respect are as follows:

8 The carrying amounts of each of the following categories, as defined in IAS 39, shall be disclosed either on the face of the statement of financial position or in the notes:
   (a) financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with IAS 39;
   (b) held-to-maturity investments;
   (c) loans and receivables;
   (d) available-for-sale financial assets;
   (e) financial liabilities measured at amortised cost.

9 An entity shall disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:
   (a) net gains or net losses on:
      (i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IAS 39;
      (ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in profit or loss for the period;
      (iii) held-to-maturity investments;
      (iv) loans and receivables; and
      (v) financial liabilities measured at amortised cost;
   (b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;
   (c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
      (i) financial assets or financial liabilities that are not at fair value through profit or loss; and
      (ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;
   (d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39; and
   (e) the amount of any impairment loss for each class of financial asset.

EXAMPLE ● Extract from the disclosures given by Findel plc in 2008 compliant with IFRS 7:

FINANCIAL INSTRUMENTS

Capital risk management

The group manages its capital to ensure that entities in the group will be able to continue as going concerns while maximising the return to stakeholders through the optimisation of the debt and equity balance. The capital structure of the group consists

of debt (£399,492,000), which includes the borrowings disclosed in note 25, cash and cash equivalents (£12,767,000) and equity attributable to equity holders of the parent, comprising issued capital (£4,255,000), reserves (£52,233,000) and retained earnings (£73,803,000) as disclosed in notes 30 to 33.

Externally imposed capital requirement
The group is not subject to externally imposed capital requirements.

Significant accounting policies
Details of the significant accounting policies and methods adopted, including the criteria for recognition, the basis of measurement and the basis on which income and expenses are recognised, in respect of each class of financial asset, financial liability and equity instrument are disclosed in note 1 to the financial statements.

Categories of financial instruments

	Carrying value	
	2008	*2007*
	£000	*£000*
Financial assets		
Held for trading	457	274
Loans and receivables (including cash and cash equivalents)	325,108	255,017
Financial liabilities		
Held for trading	315	127
Amortised cost	501,274	420,856

Financial risk management objectives
The group's financial risks include market risk (including currency risk and interest risk), credit risk, liquidity risk and cash flow interest rate risk. The group seeks to minimise the effects of these risks by using derivative financial instruments to manage its exposure. The use of financial derivatives is governed by the group's policies approved by the board of directors. The group does not enter into or trade financial instruments, including derivative financial instruments, for speculative purposes.

Market risk
The group's activities expose it primarily to the financial risks of changes in foreign currency exchange rates and interest rates. The group enters into a variety of derivative financial instruments to manage its exposure to interest rate and foreign currency risk, including:

- forward foreign exchange contracts to hedge the exchange rate risk arising on the purchase of inventory in US dollars; and
- interest rate swaps to mitigate the risk of rising interest rates.

Foreign currency risk management
The group undertakes certain transactions denominated in foreign currencies. Hence, exposures to exchange rate fluctuations arise. Exchange rate exposures are managed utilising forward foreign exchange contracts. The carrying amounts of the group's foreign currency denominated monetary assets and monetary liabilities at the reporting date are as follows:

	Assets		*Liabilities*	
	2008	*2007*	*2008*	*2007*
	£000	*£000*	*£000*	*£000*
Euro	3,286	1,436	(14)	(572)
Hong Kong dollar	—	396	(213)	(290)
US dollar	3,132	3,328	(3,419)	(2,730)

Foreign currency sensitivity analysis

A significant proportion of products sold through the group's Home Shopping and Educational Supplies divisions are procured through the group's Far East buying office. The currency of purchase for these goods is principally the US dollar, with a proportion being in Hong Kong dollars.

The following table details the group's sensitivity to a 10% increase and decrease in the Sterling against the relevant foreign currencies. 10% represents management's assessment of the reasonably possible change in foreign exchange rates. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and adjusts their translation at the period end for a 10% change in foreign currency rates. The sensitivity analysis includes external loans as well as loans to foreign operations within the group where the denomination of the loan is in a currency other than the currency of the lender or the borrower. A positive number below indicates an increase in profit and other equity where the Sterling strengthens 10% against the relevant currency. For a 10% weakening of the Sterling against the relevant currency, there would be an equal and opposite impact on the profit and other equity, and the balances below would be negative.

	Euro		*Hong Kong dollar*		*US dollar*	
	Currency impact		*Currency impact*		*Currency impact*	
	2008	*2007*	*2008*	*2007*	*2008*	*2007*
	£000	*£000*	*£000*	*£000*	*£000*	*£000*
Profit or loss and equity	(297)	(79)	19	(10)	(1,291)	(984)

[These are an extract from the disclosures; full disclosures can be seen in Findel plc 2008 Annual Report.]

12.5.3 Effective date

The standard must be applied for annual accounting periods commencing on or after 1 January 2007, although early adoption is encouraged.

IAS 32 was renamed[7] in 2005 as *Financial Instruments: Presentation*, following the transfer of the disclosure requirements to IFRS 7.

12.6 Financial instruments developments

As a result of the 2008 financial crisis and the subsequent criticism of the accounting standards on financial instruments, the IASB committed to revising IAS 39 and replacing it with a simpler standard that was easier to apply. In order to be able to progress this project quickly, the IASB split the project into a number of areas and IFRS 9 *Financial Instruments* is the outcome of the first part of the project. The areas to be considered are:

(i) recognition and measurement (IFRS 9);

(ii) impairment and the effective yield model;

(iii) hedge accounting;

(iv) derecognition of financial assets and liabilities;

(v) financial liability measurement.

By early 2010 the IASB had issued IFRS 9 and had also issued an exposure draft on the impairment model and derecognition, hedge accounting guidance is expected in 2010. IFRS 9 is mandatory from accounting periods beginning on or after 1 January 2013, but earlier adoption is permitted.

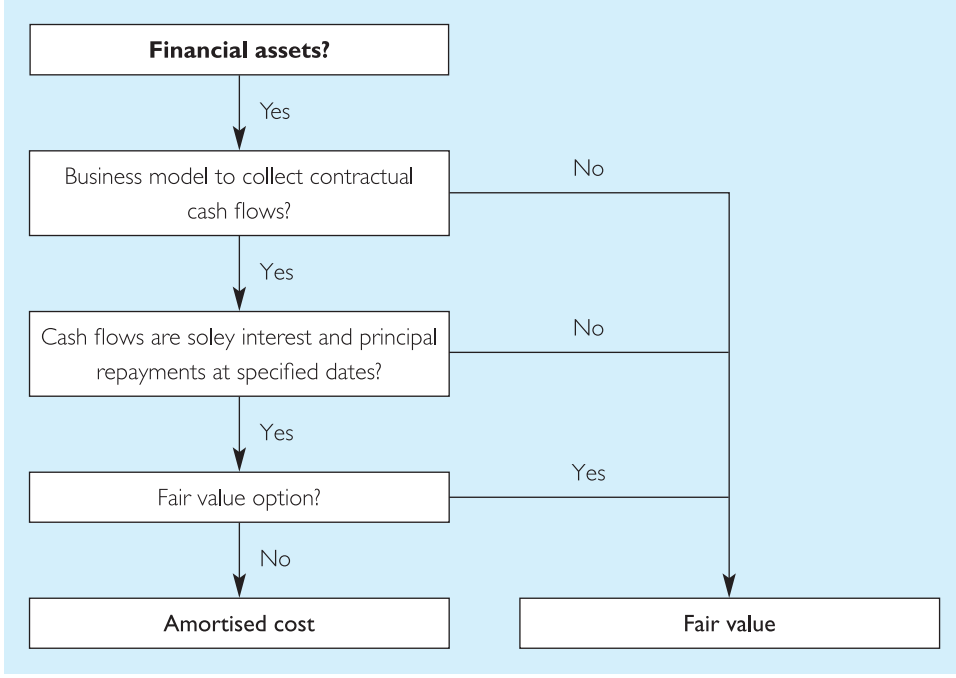
12.6.1 IFRS 9 – Recognition and measurement

As discussed earlier in this chapter, the existing IAS 39 is complex involving four different potential classifications of financial assets (held to maturity, loans and receivables, available for sale and fair value through profit or loss), each with its own measurement requirements. These classifications can be difficult to apply and also can give inconsistencies between entities and between the accounting and the commercial intentions of some instruments (highlighted in the changes made to IAS 39 to allow reclassification in 2008). The primary focus of the IASB was to simplify these categories and also to be clearer in how to determine which instruments are recognised in each category.

Classification

IFRS 9 only has two measurement bases for financial assets, fair value or amortised cost, and only allows gains and losses on equity instruments to be presented in other comprehensive income, fair value gains and losses on other instruments are recognised in profit or loss. The diagram in Figure 12.5 summarises the classification approach.

Figure 12.5 The classification approach of IFRS 9



The two key factors in determining the accounting treatment are the business model adopted by an entity for the instrument and the nature of the cash flows. The alternative business models could be to collect principal and interest or to trade the instruments by selling them on for example, and the contractual cash flows requirement ensures that an instrument held at amortised cost only exhibits basic loan features of repayment of interest and capital. IFRS 9 does however retain the fair value option in IAS 39 although it is not expected to be as significant a choice as the first two criteria will generally determine the treatment. Reclassification between the categories is only acceptable if an entity changes its business model, and only applies retrospectively.

Presentation of gains and losses

Once the measurement at fair value or amortised cost is determined, the standard gives a choice of the presentation of fair value gains and losses only for equity instruments. Any debt instruments or derivatives are measured at fair value with gains and losses in profit or loss. However, for equity instruments which are not trading instruments there is a choice for entities to present the gains and losses from movements in fair value in other comprehensive income. This choice is irrevocable and therefore subsequent reclassification is not appropriate.

12.6.2 Impairment of financial assets

The issues surrounding impairment have proved difficult for the IASB and they have faced significant pressure to change the current impairment models in IAS 39, in particular for instruments measured at amortised cost. To the date of writing this text the IASB has issued an exposure draft on amortised cost and impairment but final guidance has not been issued. Below we discuss the major concern that the IASB has been asked to address and its initial proposals in the exposure draft, ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*.

Incurred v expected losses

The debate on impairment largely revolves around whether financial asset impairment should be calculated following an incurred or expected loss model. IAS 39 uses an incurred loss model, however, in the 2008 financial crisis many commentators have suggested that this model delayed the recognition of losses on loans resulting in misleading results for financial institutions. The key difference between the two approaches is that an incurred loss model only provides for impairments when an event has occurred that causes that impairment. An expected loss model, however, provides for impairment if there is reason to expect that it will arise at some point over the life of the loan even if it has not arisen at the balance sheet date. For example, if a bank makes a loan to a customer and the customer becomes unemployed and therefore defaults on the loan, under the incurred loss model an impairment would only be recognised when the customer loses his job. Under the expected loss model, the bank would have made an estimate of the likelihood of the customer losing his job from the inception of the loan and provide based on that probability. The provision on the expected loss model is therefore recognised earlier but it does depend much more on the estimation and judgement of management of a company.

ED/2009/12 has been issued to address impairment and the way that the amortised cost method of accounting is applied. The ED proposes an expected loss model but does this by proposing changes in the way that the amortised cost model is applied. The amortised cost model determines an effective interest rate by determining the rate at which the initial loan and the cash flows over its life are discounted to zero, effectively the internal rate of return on the loan. The current IAS 39 requires the rate to be determined on cash flows before

future credit losses, whereas the exposure draft requires the calculation on cash flows including expected future credit losses. Every period the expected cash flows need to be adjusted and discounted back at the original effective rate, and difference in the loan value is adjusted against profit or loss. The impact of this new approach is that losses would tend to be recognised earlier and no separate impairment model is required; if impairment is expected, the cash flow estimates will automatically adjust for that. It is still to be seen how straightforward the approach will be in practice and whether financial institutions can adapt their systems and processes easily to the revised approach.

12.6.3 Derecognition of financial assets

The IASB is looking at derecognition of financial assets as a separate project to the replacement of IAS 39. By early 2010 an exposure draft had been issued but it was not clear in its approach and consequently any new standard may differ from the approach in the exposure draft. As with impairment, there are two distinct views on the basis on which derecognition decisions should be made and the members of the IASB continue to debate which approach is preferable. The two approaches differ in that one considers prior ownership of an asset should influence continuing recognition, whereas the other approach does not consider prior ownership in the decision to recognise an asset. To illustrate this consider the example below.

Illustration of derecognition approaches

A company owns a portfolio of receivables worth €1 million. It sells the receivables to a finance company for €1 million and gives the finance company a guarantee over default in any of the receivable balances provided that the finance company continues to hold them.

Approach 1 – The company has not transferred the significant risks and rewards of ownership or control of the receivables (restriction on finance company selling) and therefore they should not be derecognised. The €1 million received on sale should be treated as a liability.

Approach 2 – The company has sold the receivables and only has left a credit default guarantee which should be recognised as a derivative at fair value with gains and losses in profit or loss.

Currently IAS 39 uses a version of approach 1, however, if a company had simply given a guarantee on €1 million of another entity's debts, approach 2 would be used. Supporters of approach 2 say that the obligation is no different regardless of whether the receivables had been previously owned and therefore it is inconsistent to have different accounting treatments. We need to await the outcome of the IASB deliberations to get a final position on this issue.

Summary

This chapter has given some insight into the difficulties and complexities of accounting for financial instruments and the ongoing debate on this topic, highlighted by the financial crisis that began in 2008. The approach of the IASB is to adhere to the principles contained in the *Framework* but to also issue guidance that is robust enough to prevent manipulation and abuse. Whether the IASB has achieved this is open to debate. Some might view the detailed requirements of the standards, particularly IAS 39, to be

so onerous that companies will not be able to show their real intentions in the financial statements. This would be particularly true, for instance, with the detailed criteria on hedging. These criteria have led to many businesses not hedge accounting even though they are hedging commercially to manage their risks. The hedge accounting criteria do not fit with the way they run or manage their risk profiles.

The standards are still developing and problems have already been identified. Since December 2003 there have already been many amendments to the standards.

As can be seen there is much to criticise these standards about, but it should be borne in mind that the IASB has grasped this issue better than many other standard setters. Financial instruments may be complex and subject to debate but guidance is required in this area, and the IASB has given guidance where many others have not.

In addition to giving an insight into the development of standards, our aim has been that you should be able to calculate the debt/equity split on compound instruments and the finance cost on liability instruments and classify and account for the four categories of financial instrument.

REVIEW QUESTIONS

1 Explain what is meant by the term split accounting when applied to convertible debt or convertible preference shares and the rationale for splitting.

2 Discuss the implications for a business if a substance approach is used for the reporting of convertible loans.

3 Explain how a gain or loss on a forward contract is dealt with in the accounts if the contract is not completed until after the period end.

4 Explain how redeemable preference shares, perpetual debt, loans and equity investments are reported in the financial statements.

5 The authors[8] contend that the use of current valuations can present an inaccurate view of a firm's true financial status. When assets are illiquid, current value represents only a guess. When assets participate in an economic 'bubble', current value is invariably unsustainable. Accounting standards, the authors conclude, should be flexible enough to fairly assess value in these circumstances. Discuss the alternatives that standard setters could permit in order to fairly assess values in an illiquid market.

6 Disclosure of the estimated fair values of financial instruments is better than adjusting the values in the financial statements with the resulting volatility that affects earnings and gearing ratios. Discuss.

7 Companies were permitted in 2009 to reclassify financial instruments that were initially designated as at fair value through profit. Critically discuss the reasons for the standard setters changing the existing standard.

8 Explain the difference between the incurred loss model and the expected loss model in determining impairment and suggest limitations of both approaches.

9 The only true way to simplify IAS 39 would be for all financial assets and liabilities to be measured at fair value with gains and losses recognised in profit or loss. Discuss.

EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

* Question 1

On 1 April year 1, a deep discount bond was issued by DDB AG. It had a face value of £2.5 million covering a five-year term. The lenders were granted a discount of 5%. The coupon rate was 10% on the principal sum of £2.5 million, payable annually in arrears. The principal sum was repayable in cash on 31 March year 5. Issuing costs amounted to £150,000.

Required:

Compute the finance charge per annum and the carrying value of the loan to be reported in each year's profit or loss and statement of financial position respectively.

Question 2

On 1 October year 1, RPS plc issued one million £1 5% redeemable preference shares. The shares were issued at a discount of £50,000 and are due to be redeemed on 30 September Year 5. Dividends are paid on 30 September each year.

Required:

Show the accounting treatment of the preference shares throughout the life-span of the instrument calculating the finance cost to be charged to profit or loss in each period.

Question 3

October 20X1, Little Raven plc issued 50,000 debentures, with a par value of £100 each, to investors at £80 each. The debentures are redeemable at par on 30 September 20X6 and have a coupon rate of 6%, which was significantly below the market rate of interest for such debentures issued at par. In accounting for these debentures to date, Little Raven plc has simply accounted for the cash flows involved, namely:

- On issue: Debenture 'liability' included in the statement of financial position at £4,000,000.
- Statements of comprehensive income: Interest charged in years ended 30 September 20X2, 20X3 and 20X4 (published accounts) and 30 September 20X5 (draft accounts) – £300,000 each year (being 6% on £5,000,000).

The new finance director, who sees the likelihood that further similar debenture issues will be made, considers that the accounting policy adopted to date is not appropriate. He has asked you to suggest a more appropriate treatment.

Little Raven plc intends to acquire subsidiaries in 20X6.

Statements of comprehensive income for the years ended 30 September 20X4 and 20X5 are as follows:

	Y/e 30 Sept 20X5 (Draft) £000	*Y/e 30 Sept 20X4 (Actual) £000*
Turnover	6,700	6,300
Cost of sales	(3,025)	(2,900)
Gross profit	3,675	3,400
Overheads	(600)	(550)
Interest payable – debenture	(300)	(300)
– others	(75)	(50)
Profit for the financial year	2,700	2,500
Retained earnings brought forward	4,300	1,800
Retained earnings carried forward	7,000	4,300

Extracts from the statement of financial position are:

	At 30 Sept 20X5 (Draft) £000	*At 30 Sept 20X4 (Actual) £000*
Share capital	2,250	2,250
Share premium	550	550
Retained earnings	7,000	4,300
	9,800	7,100
6% debentures	4,000	4,000
	13,800	11,100

Required:

(a) Outline the considerations involved in deciding how to account for the issue, the interest cost and the carrying value in respect of debenture issues such as that made by Little Raven plc. Consider the alternative treatments in respect of the statement of comprehensive income and refer briefly to the appropriate statement of financial position disclosures for the debentures. Conclude in terms of the requirements of IAS 32 (on accounting for financial instruments) in this regard.

(b) Detail an alternative set of entries in the books of Little Raven plc for the issue of the debentures and subsequently; under this alternative the discount on the issue should be dealt with under the requirements of IAS 32. The constant rate of interest for the allocation of interest cost is given to you as 11.476%. Draw up a revised statement of comprehensive income for the year ended 30 September 20X5 – together with comparatives – taking account of the alternative accounting treatment.

Question 4

On 1 January 2009 Henry Ltd issued a convertible debenture for €200 million carrying a coupon interest rate of 5%. The debenture is convertible at the option of the holders into 10 ordinary shares for each €100 of debenture stock on 31 December 2013. Henry Ltd considered borrowing the €200 million through a conventional debenture that repaid in cash, however, the interest rate that could be obtained was estimated at 7%, therefore Henry Ltd decided on the issue of the convertible.

Required:

Show how the convertible bond issue will be recognised on 1 January 2009 and determine the interest charges that are expected in the statement of comprehensive income over the life of the convertible bond.

* Question 5

George plc adopted IFRS for the first time on 1 January 2008 and has three different instruments whose accounting George is concerned will change as a result of the adoption of the standard. The three instruments are:

1 An investment in 15% of the ordinary shares of Joshua Ltd, a private company. This investment cost €50,000, but had a fair value of €60,000 on 1 January 2008, €70,000 on 31 December 2008 and €65,000 on 31 December 2009.

2 An investment of €40,000 in 6% debentures. The debentures were acquired at their face value of €40,000 on 1 July 2007 and pay interest half yearly in arrears on 31 December and 30 June each year. The bonds have a fair value of €41,000 at 1 January 2008, €43,000 at 31 December 2008 and €38,000 at 31 December 2009.

3 An interest rate swap taken out to swap floating rate interest on an outstanding loan to fixed rate interest. Since taking out the swap the loan has been repaid, however, George plc decided to retain the swap as it was 'in the money' at 1 January 2008. The fair value of the swap was a €10,000 asset on 1 January 2008, however, it became a liability of €5,000 by 31 December 2008 and the liability increased to €20,000 by 31 December 2009. In 2008 George paid €1,000 to the counterparty to the swap and in 2009 paid €5,000 to the counterparty.

Required:

Show the amount that would be recognised for all three instruments in the statement of financial position, in profit and loss and in other comprehensive income on the following assumptions:

(i) Equity and debt investments are available for sale.

(ii) Where possible, investments are treated as held to maturity.

(iii) Where equity investments are treated as fair value through profit and loss and debt investments are treated as loans and receivables.

Question 6

Isabelle Limited borrows £100,000 from a bank on the following terms:

(i) Arrangement fees of £2,000 are charged by the bank and deducted from the initial proceeds on the loan;

(ii) Interest is payable at 5% for the first 3 years of the loan and then increases to 7% for the remaining 2 years of the loan;

(iii) The full balance of £100,000 is repaid at the end of year 5.

Required:

(a) What interest should be recognised in the statement of comprehensive income for each year of the loan?

(b) If Isabelle Limited repaid the loan after 3 years for £100,000 what gain or loss would be recognised in the statement of comprehensive income?

Question 7

A company borrows on a floating rate loan, but wishes to hedge against interest variations so swaps the interest for fixed rate. The swap should be perfectly effective and has zero fair value at inception. Interest rate increase and therefore the swap becomes a financial asset to the company at fair value of £5 million.

Required:
Describe the impact on the financial statements for the following situations:
(a) The swap is accounted for under IAS 39, but is not designated as a hedge.
(b) The swap is accounted for under IAS 39, and is designated as a hedge.

Question 8

Charles plc is applying IAS 32 and IAS 39 for the first time this year and is uncertain about the application of the standard. Charles plc balance sheet is as follows:

	£000	*Financial asset/liability*	*IAS 32/39?*	*Category*	*Measurement*
Non-current assets					
Goodwill	2,000				
Intangible	3,000				
Tangible	6,000				
Investments					
Corporate bond	1,500				
Equity trade investments	900				
	13,400				
Current assets					
Inventory	800				
Receivables	700				
Prepayments	300				
Forward contracts (note 1)	250				
Equity investments held for future sale	1,200				
	3,250				
Current liabilities					
Trade creditors	(3,500)				
Lease creditor	(800)				
Income tax	(1,000)				
Forward contracts (note 1)	(500)				
	(5,800)				
Non-current liabilities					
Bank loan	(5,000)				
Convertible debt	(1,800)				
Deferred tax	(500)				
Pension liability	(900)				
	(8,200)				
Net assets	**2,650**				

Note

1 The forward contracts have been revalued to fair value in the balance sheet. They do not qualify as hedging instruments.

Required:

For the above balance sheet consider whether, under the IAS 39:

(i) Which items on the balance sheet are financial assets/liabilities?

(ii) Are the balances within the scope of IAS 39?

(iii) How they should be classified under IAS 39:

HTM	Held to maturity
LR	Loans and receivables
FVPL	Fair value through profit and loss
AFS	Available for sale
FL	Financial liabilities

(iv) How they should be measured under IAS 39:

FV	Fair value
C	Amortised cost

Assume that the company only includes items in 'fair value through profit and loss' when required to do so, and also chooses where possible to include items in 'loans and receivables'.

References

1 IAS 32 *Financial Instruments: Disclosure and Presentation*, IASC, revised 1998.
2 *Ibid*., para. 5.
3 *Ibid*., para. 18.
4 *Ibid*., para. 23.
5 *Ibid*., para. 33.
6 IFRS 7 *Financial Instruments: Disclosures*, IASB, 2005.
7 IAS 32 *Financial Instruments: Presentation*, IASB, revised 2005.
8 S. Fearnley and S. Sunder 'Bring Back Prudent', *Accountancy*, 2007, 140(1370), pp. 76–77.