

**UNDERSTANDING
FINANCIAL
INSTRUMENT
(PART 1)**

BY

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Introduction

This article will be the first in the series on financial instruments. Subsequent editions will focus on the new requirement of IFRS 9 – Financial Instruments on classification and measurement, impairment model and hedge accounting. The purpose of this part one of the article is to provide an introduction to IFRS requirements for financial instruments under IAS 39 Financial Instruments – Recognition and Measurement. It is intended to set out the basic principles for the recognition of financial asset or financial liability in the statement of financial position as well as the classification and measurement of a financial asset or financial liability into different categories. Since IAS 39 Financial Instruments - Recognition and Measurement is still being applied by entities in jurisdictions where IFRS 9 is yet to be adopted e.g. Nigeria, these principles are an important underpinning for the further development of knowledge in this area.

Useful Background

The predecessor body of International Accounting Standards Board (IASB), the International Accounting Standards Committee (IASC) started work on financial instruments since 1998 and the subject has actively remained on the front-burner of the Board since then. Upon succeeding the IASC in 2001, the IASB has made several amendments to IAS 32 and IAS 39 and subsequently issued IFRS 7 – Financial Instruments: Disclosures in August 2005. In that same year (2005), the IASB began working towards a long-term project aimed at improving and simplifying the reporting for financial instruments. This was completed on 24 July 2014 when the IASB issued the completed version of IFRS 9 Financial Instruments replacing IAS 39.

IFRS 9 will come into effect for annual periods beginning on or after 1 January 2018 with earlier application permitted. Until IFRS 9 become mandatory, different entities applying IFRS requirements will use different IFRS requirements for financial instruments. In the meantime, entities applying IAS 39 or early applying only part of IFRS 9 must, in accordance with paragraph 30 of IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors, disclose the fact that they are yet to apply IFRS 9. They are also required to disclose known or reasonable estimate information relevant to assessing the possible impact that application of IFRS 9 will have on the entity's financial statements in the period of initial application. Consequently, such entities must also be familiar with the requirements set out in IFRS 9.

So, what is Financial Instrument?

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

The definition is wide and includes cash, deposits in other entities, trade receivables, loans to other entities, investments in debt instruments, investments in shares and other equity instruments.

A financial asset is any asset that is:

- cash
- a contractual right:
 - to receive cash or another financial asset from another entity
 - to exchange financial asset of financial liabilities with another entity under conditions that are potentially favourable to the entity
- an equity instrument of another entity.
- a contract that will or may be settled in the entity's own equity instruments and is:
 - i. a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Examples of financial asset include trade receivables, options, investment in equity shares.

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

- a contractual obligation:
 - to deliver cash or another financial asset to another entity
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- a contract that will or may be settled in the entity's own equity instruments and is:
 - i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Examples are trade payables, loans from other entities, and debt instruments issued by the entity e.g. debenture loans, redeemable preference shares.

Equity Instrument is any contract that evidences a residual interest in the asset of an entity after deducting all of its liabilities.

Scope

Apart from items that meet the above definitions, IAS 39 also applies to more complex, derivative financial instruments such as call options, put options, forwards, futures, and swaps. Derivatives are contracts that allow entities to speculate on future changes in the market at a relatively low or no initial cost. The standard requires derivatives to be measured at fair value with changes in fair value recognised either in profit or loss or in reserves depending on whether the company uses hedging.

A derivative is a financial instrument which has the following characteristics:

- a. its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating, credit index or other variable
- b. it requires no initial net investment or the investment is small
- c. it is settled at a future date

IAS 39 also applies to some contracts that do not meet the definition of a financial instrument, but have characteristics similar to derivative financial instruments. This means that IAS 39 applies to contracts to purchase or sale of non-financial items such as precious metals at a future date when the following applies:

- the contract is subject to possible net settlement which is the situation where the entity can settle the contract net in cash rather than by delivering or receiving for example a precious metal or a commodity
- the contract is not part of the normal purchase or sale requirements of the entity. If the purchase of the precious metal was normal for the entity then it is excluded from the scope of IAS 39.

Scope Exclusion

IAS 39 does not apply to an entity's own issued equity instruments. Investments in equity instruments issued by other entities, however, are financial assets. IAS 39 also provides exceptions for some other items that meet the definition of a financial instrument as they are accounted for under other IFRS. For example, investments in subsidiaries, associates and joint ventures are accounted for under IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial Statement or IAS 28 Investments in Associates and Joint Ventures whilst employers' assets and liabilities under employee benefit plans, are accounted for under IAS 19, Employee Benefits.

Recognition

An entity should recognise a financial asset or financial liability on its statement of financial position when the entity becomes a party to the contractual provisions of the instrument rather than when the contract is settled. Thus derivatives are recognised in the financial statements even though the entity may have paid or received nothing on entering into the derivative. IAS 39 is a partial rather than a full fair value model. Financial assets and liabilities are measured at cost, fair value or amortised cost depending upon their classification.

Classification

Essentially, classification of financial instruments under IAS 39 is guided by management's intention and ability whilst a substance over form model is applied to debt/equity classification. The critical test is whether the issuer has discretion over the transfer of benefits (e.g. cash). If the issuer has no discretion over payment, then the instrument is a liability. Thus certain instruments, such as redeemable preference shares, will be shown as liabilities.

Under IAS 39, there are four clearly defined categories of financial assets and two clearly defined categories of financial liabilities. The classification of a financial asset or financial liability determines:

- the measurement of the item (at cost, amortised cost or fair value)
- where the gain or loss should be recognised (either in profit or loss or in equity (reserves)).

All financial assets, including derivatives, are recognised on the statement of financial position under IFRS. They are initially measured at fair value plus or minus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the asset.

Financial assets

An entity is required to classify its financial assets into one of the following four categories:

- **Held-to-maturity** investments
- **Available-for-sale** financial assets
- **Loans** and receivables
- **Financial** assets at fair value through profit or loss

Remember your acronym – ‘HALF’

Financial assets at fair value through profit or loss

These are financial assets that the entity either holds for trading purposes or upon initial recognition it designates as at fair value through profit or loss. A entity may use this latter designation when doing so results in more relevant information by eliminating or significantly reducing a measurement or recognition inconsistency (an accounting mismatch) or where a group of financial assets and/or financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the assets and/or liabilities is provided internally to the entity's key management personnel. Derivative assets are always treated as held for trading unless they are effective hedging instruments.

Financial assets at fair value through profit or loss are re-measured to fair value at each subsequent reporting date until the assets are de-recognised. The gains and losses arising from changes in fair value are included in profit or loss in the period in which they occur. Gains and losses will include both realised gains and losses arising on the disposal of these financial assets and unrealised gains and losses arising from changes in the fair value of the assets still held.

Held-to-maturity investments

These are investments in debt instruments that the entity will not sell before their maturity date irrespective of changes in market prices or the entity's financial position or performance. Investments in shares generally do not have a maturity date, and thus should not be classified as held-to-maturity investments. IAS 39 requires a positive intent and ability to hold a financial asset to maturity.

In order to be classified as held-to-maturity, a financial asset must also be quoted in an active market. This fact distinguishes held-to-maturity investments from loans and receivables. Loans and receivables, and financial assets that are held for trading, including derivatives, cannot be classified as held-to-maturity investments. Floating rate debt is considered to have determinable payments and can therefore be included in the held-to-maturity category.

When an entity's actions cast doubt on its intent or ability to hold investments to maturity, the entity is prohibited from using the held-to-maturity category for a reasonable period of time. A penalty is therefore effectively imposed for a change in management's intention. The entity is forced to reclassify all its held-to-maturity investments as available-for-sale (see below) and measure them at fair value until it is able, through subsequent actions, to restore faith in its intentions. An entity may not classify any financial assets as held to maturity if during the current or preceding two years it has sold or reclassified more than an insignificant amount of held to maturity investments except in very narrowly defined circumstances.

Held-to-maturity assets are subsequently carried at amortised cost, and are subject to impairment testing.

Loans and receivables

These are financial assets with fixed or determinable payments that are not quoted in an active market. An entity can classify account receivables, and loans to customers in this category. Financial assets with a quoted price in an active market and financial assets that are held for trading, including derivatives, cannot be classified as loans and receivables. This category differs from held-to-maturity investments as there is no requirement that the entity shows an intention to hold the loans and receivables to maturity. If it is thought that the owner of the asset may not recover all of the investment other than because of credit deterioration, then the asset may not be classified as loans and receivables.

Loans and receivables are subsequently measured at amortised cost and are subject to impairment testing. Amortised cost is discussed below.

Available-for-sale financial assets (AFS)

This is the default (or residual) category for all other financial assets that do not fall into any of the other categories or those assets that the entity has elected to classify into this category. For example, an entity could classify some of its investments in debt and equity instruments as available-for-sale financial assets. Financial assets that are held for trading, including derivatives, cannot be classified as available-for-sale financial assets. The AFS category will include all equity securities except those classified as fair value through profit or loss.

Available-for-sale financial assets are carried at fair value subsequent to initial recognition. There is a presumption that fair value can be readily determined for most financial assets either by reference to an active market or by a reasonable estimation process. The only exemptions to this are equity securities that do not have a quoted market price in an active market and for which a reliable fair value cannot be reliably measured. Such instruments are measured at cost instead of fair value.

For available-for-sale financial assets, unrealised holding gains and losses are deferred in reserves (OCI) until they are realised or impairment occurs. Only interest income and dividend income, impairment losses, and certain foreign currency gains and losses are recognised in profit or loss.

Financial liabilities

There are two categories of financial liabilities:

- at fair value through profit or loss
- at amortised cost.

These include financial liabilities that the entity either holds for trading purposes or upon initial recognition it designates as at fair value through profit or loss. The conditions to be met in order to designate a financial liability at fair value through profit or loss are the same as for financial assets. Derivative liabilities are always treated as held for trading unless they are designated and effective hedging instruments.

An issued debt instrument that the entity intends to repurchase soon to make a gain from short-term movements in interest rates is an example of a liability held for trading. Financial liabilities measured at amortised cost are the default category for financial liabilities that do not meet the definition of financial liabilities at fair value through profit or loss. For most entities, most financial liabilities will fall into this category. Examples of financial liabilities that generally would be classified in this category are accounts payables, loan notes payable, issued debt instruments, and deposits from customers.

Reclassification

IAS 39 restricts the ability to reclassify financial assets and financial liabilities to another category. The major reason for these restrictions is to prevent entities from being able to manage their earnings. Reclassifications in or out of the fair value through profit and loss category are not permitted. Reclassifications between the available for sale (**AFS**) and held to maturity categories (**HTM**) are possible, although reclassifications of a significant amount of **HTM** investments would necessitate reclassification of all remaining **HTM** investments to **AFS** as set out above. An entity also cannot reclassify from loans and receivables to **AFS**.

Measurement

When a financial asset or financial liability is recognised initially in the statement of financial position, the asset or liability is measured at fair value (plus or minus transaction costs in some cases). Since fair value is a market price, on initial recognition, fair value may not equal the amount of consideration paid or received for the financial asset or financial liability.

Examples

1. A debt security that is held for trading is purchased for ₦10,000. Transaction costs are ₦600. The initial carrying amount is ₦10,000 and the transaction costs of ₦600 are expensed. This treatment applies because the debt security is classified as held for trading and, therefore, measured at fair value with changes in fair value recognised in profit or loss.
2. A bond classified as available for sale is purchased for ₦120,000 and transaction costs are ₦1000. The initial carrying amount is ₦121,000, i.e. the amount paid for the bond and the transaction costs. This

treatment applies because the bond is not measured at fair value with changes in fair value recognised in profit or loss. Any changes in fair value of the bond are taken to reserves until the bond is sold.

Subsequent measurement

Subsequent to initial recognition, financial assets and financial liabilities are measured using one of the following methods:

- cost
- amortised cost
- fair value.

Whether a financial asset or financial liability is measured at cost, amortised cost, or fair value depends on its classification above and whether its fair value can be reliably determined.

Subsequent to initial recognition, only one type of financial instrument is measured at cost and that is investments in unquoted equity instruments that cannot be reliably measured at fair value.

Amortised cost

Amortised cost is the cost of an asset or liability adjusted to achieve a constant effective interest rate over the life of the asset or liability. An entity must apply the effective interest rate method in the measurement of amortised cost. The effective interest rate method also determines how much interest income or interest expense should be reported in profit and loss.

Fair value

IAS 39 establishes rules for determining fair value. The existence of a published price quoted in an active market is the best evidence of fair value.

For assets or liabilities that are not quoted in an active market, fair value is determined using valuation techniques, such as discounted cash flow models or option-pricing models.

Derecognition of financial assets

Derecognition of a financial asset occurs where:

1. the contractual rights to the cash flows from the financial asset expire, or
2. the financial asset has been transferred (e.g. sold) and the transfer qualifies for de-recognition based on the extent of the transfer of the risks and rewards of ownership of the financial asset.

The contractual rights to cash flows may expire if a customer has paid off an obligation to the company or an option held by the company has expired. De-recognition occurs because the rights associated with the financial asset do not now exist.

When a company sells or transfers a financial asset to another party, the company must evaluate the extent to which it has transferred the risks and rewards of ownership. The risks and rewards of ownership are transferred where the seller does not retain any rights or obligations associated with the sold asset or where the seller retains a right to repurchase the financial asset in the future at the current fair value of the asset.

For example a company retains substantially all risks and rewards of ownership where the asset will be returned to the company for a fixed price at a future date. Here the sale would not qualify for de-recognition.

Examples

If a company sells an investment in shares, but retains the right to repurchase the shares at any time at a price equal to their current fair value then it should derecognise the asset.

If a company sells an investment in shares and enters into an agreement whereby the buyer will return any increases in value to the company and the company will pay the buyer interest plus compensation for any decrease in the value of the investment, then the company should not derecognise the investment as it has retained substantially all the risks and rewards.

Derecognition of financial liabilities

The de-recognition criteria for financial liabilities are different from those for financial assets. There is no requirement to assess the extent to which the company has retained risks and rewards in order to derecognise a financial liability. The de-recognition requirements focus on whether the financial liability has been extinguished.

Impairment of financial assets under IAS 39

IAS 39 requires an assessment at each reporting date as to whether there is any objective evidence that a financial asset is impaired and whether any impairment has any impact on the estimated future cash flows of the financial asset. The company recognises any impairment loss in profit or loss. Losses expected from future events are not recognised.

Objective evidence of impairment includes observable data about the loss events such as financial difficulty, breach of contract and bankruptcy. For investments in equity instruments that are classified as available for sale, a significant and prolonged decline in fair value below its cost is objective evidence of impairment. The only category of financial asset that is not subject to testing for impairment is financial assets at fair value through profit or loss, since any decline in value for such assets is recognised immediately. Financial liabilities are not subject to impairment testing.

For loans and receivables and held-to-maturity investments, impaired assets are measured at the present value of the estimated future cash flows discounted using the original effective interest rate of the financial asset.

Reversals of impairment losses

Impairment losses for loans and receivables, held-to-maturity investments, and investments in debt instruments classified as available-for-sale are reversed through profit or loss if the impairment losses decrease and the decrease can be related to an event occurring after the impairment was recognised.

Impairment losses for investments in equity instruments are never reversed in profit or loss until the investments are sold.(or recycled into profit or loss).The difference in treatment of reversals is due to the fact that it is more difficult to distinguish reversals of impairment losses from other increases in fair value for investments in equity instruments.

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