**Financial Instruments**

***IAS 39 and IAS 32 Financial assets and liabilities***

**Scope exclusions**

IAS 39 applies to all types of financial instruments except for the following,

which are scoped out of IAS 39:

interests in subsidiaries, associates, and joint ventures accounted for

under IAS 27, IAS 28, or IAS 31; however IAS 39 applies in cases

where under IAS 27, IAS 28 or IAS 31 such interests are to be

accounted for under IAS 39. The standard also applies to derivatives

on an interest in a subsidiary, associate, or joint venture

employers' rights and obligations under employee benefit plans to

which IAS 19 applies

contracts in a business combination to buy or sell an acquire at a

future date

rights and obligations under insurance contracts, except IAS 39 does

apply to financial instruments that take the form of an insurance (or

reinsurance) contract but that principally involve the transfer of

financial risks and derivatives embedded in insurance contracts

financial instruments that meet the definition of own equity under IAS

32

financial instruments, contracts and obligations under share-based

payment transactions to which IFRS 2 applies

rights to reimbursement payments to which IAS 37 applies

***Definitions***

Financial instrument: a contract that gives rise to a financial asset of one

entity and a financial liability or equity instrument of another entity.

Financial asset: any asset that is:

cash;

an equity instrument of another entity;

a contractual right:

o to receive cash or another financial asset from another entity

or

o to exchange financial assets or financial liabilities with another

entity under conditions that are potentially favourable to the

entity or

a contract that will or may be settled in the entity's own equity

instruments and is:

o 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

o 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. For

this purpose the entity's own equity instruments do not include

instruments that are themselves contracts for the future receipt

or delivery of the entity's own equity instruments; they also do

not include puttable financial instruments

Financial liability: any liability that is:

a contractual obligation:

o to deliver cash or another financial asset to another entity; or

o to exchange financial assets or financial liabilities with another

entity under conditions that are potentially unfavourable to the

entity; or

a contract that will or may be settled in the entity's own equity

instruments and is:

o 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

o 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. For

this purpose the entity's own equity instruments do not

include: instruments that are themselves contracts for the

future receipt or delivery of the entity's own equity instruments

or puttable instruments

**Common Examples of Financial Instruments Within the**

**Scope of IAS 39**

cash

demand and time deposits

commercial paper

accounts, notes, and loans receivable and payable

debt and equity securities. These are financial instruments

from the perspectives of both the holder and the issuer.

This category includes investments in subsidiaries,

associates, and joint ventures

asset backed securities such as collateralised mortgage

obligations, repurchase agreements, and securitised

packages of receivables

derivatives, including options, rights, warrants, futures

contracts, forward contracts, and swaps.

A derivative is a financial instrument:

Whose value changes in response to the change in an underlying

variable such as an interest rate, commodity or security price, or

index;

That requires no initial investment, or one that is smaller than would

be required for a contract with similar response to changes in market

factors; and

That is settled at a future date.

**Examples of Derivatives**

**Forwards:** Contracts to purchase or sell a specific quantity of a

financial instrument, a commodity, or a foreign currency at a

specified price determined at the outset, with delivery or

settlement at a specified future date. Settlement is at maturity by

actual delivery of the item specified in the contract, or by a net

cash settlement.

**Interest Rate Swaps and Forward Rate Agreements:** Contracts

to exchange cash flows as of a specified date or a series of

specified dates based on a notional amount and fixed and floating

rates.

**Futures:** Contracts similar to forwards but with the following

differences: futures are generic exchange-traded, whereas

forwards are individually tailored. Futures are generally settled

through an offsetting (reversing) trade, whereas forwards are

generally settled by delivery of the underlying item or cash

settlement.

**Options:** Contracts that give the purchaser the right, but not the

obligation, to buy (call option) or sell (put option) a specified

quantity of a particular financial instrument, commodity, or foreign

currency, at a specified price (strike price), during or at a specified

period of time. These can be individually written or exchangetraded.

The purchaser of the option pays the seller (writer) of the

option a fee (premium) to compensate the seller for the risk of

**International Financial Reporting Standards Workbook**

Revision 0.1 Magenta Financial Training March 2011 Page 161

payments under the option.

**Caps and Floors:** These are contracts sometimes referred to as

interest rate options. An interest rate cap will compensate the

purchaser of the cap if interest rates rise above a predetermined

rate (strike rate) while an interest rate floor will compensate the

purchaser if rates fall below a predetermined rate.

***Embedded Derivatives***

Some contracts that themselves are not financial instruments may

nonetheless have financial instruments embedded in them. For example, a

contract to purchase a commodity at a fixed price for delivery at a future

date has embedded in it a derivative that is indexed to the price of the

commodity.

An embedded derivative is a feature within a contract, such that the cash

flows associated with that feature behave in a similar fashion to a standalone

derivative. In the same way that derivatives must be accounted for at

fair value on the balance sheet with changes recognised in the income

statement, so must some embedded derivatives. IAS 39 requires that an

embedded derivative be separated from its host contract and accounted for

as a derivative when:

the economic risks and characteristics of the embedded derivative

are not closely related to those of the host contract

a separate instrument with the same terms as the embedded

derivative would meet the definition of a derivative, and

the entire instrument is not measured at fair value with changes in

fair value recognised in the income statement

If an embedded derivative is separated, the host contract is accounted for

under the appropriate standard (for instance, under IAS 39 if the host is a

financial instrument). Appendix A to IAS 39 provides examples of embedded

derivatives that are closely related to their hosts, and of those that are not.

Examples of embedded derivatives that are not closely related to their hosts

(and therefore must be separately accounted for) include:

the equity conversion option in debt convertible to ordinary shares

(from the perspective of the holder only) [IAS 39.AG30(f)]

commodity indexed interest or principal payments in host debt

contracts[IAS 39.AG30(e)]

cap and floor options in host debt contracts that are in-the-money

when the instrument was issued [IAS 39.AG33(b)]

leveraged inflation adjustments to lease payments [IAS 39.AG33(f)]

currency derivatives in purchase or sale contracts for non-financial

items where the foreign currency is not that of either counterparty to

the contract, is not the currency in which the related good or service

is routinely denominated in commercial transactions around the

world, and is not the currency that is commonly used in such

contracts in the economic environment in which the transaction takes

place. [IAS 39.AG33(d)]

If IAS 39 requires that an embedded derivative be separated from its host

contract, but the entity is unable to measure the embedded derivative

separately, the entire combined contract must be designated as a financial

asset as at fair value through profit or loss).

***Classification of Financial Assets***

IAS 39 requires financial assets to be classified in one of the following

categories:

Financial assets at fair value through profit or loss

Available-for-sale financial assets

Loans and receivables

Held-to-maturity investments

Those categories are used to determine how a particular financial asset is

recognised and measured in the financial statements.

**Financial assets at fair value through profit or loss.** This category has

two subcategories:

**Designated.** The first includes any financial asset that is designated on

initial recognition as one to be measured at fair value with fair value

changes in profit or loss.

**Held for trading.** The second category includes financial assets that are

held for trading. All derivatives (except those designated hedging

instruments) and financial assets acquired or held for the purpose of selling

in the short term or for which there is a recent pattern of short-term profit

taking are held for trading.

**Available-for-sale financial assets (AFS)** are any non-derivative financial

assets designated on initial recognition as available for sale or any other

instruments that are not classified as as (a) loans and receivables, (b) heldto-

maturity investments or (c) financial assets at fair valoue through profit or

loss. [IAS 39.9] AFS assets are measured at fair value in the balance sheet.

Fair value changes on AFS assets are recognised directly in equity, through

the statement of changes in equity, except for interest on AFS assets (which

is recognised in income on an effective yield basis), impairment losses and

(for interest-bearing AFS debt instruments) foreign exchange gains or

losses. The cumulative gain or loss that was recognised in equity is

recognised in profit or loss when an available-for-sale financial asset is

derecognised.

**Loans and receivables** are non-derivative financial assets with fixed or

determinable payments that are not quoted in an active market, other than

held for trading or designated on initial recognition as assets at fair value

through profit or loss or as available-for-sale. Loans and receivables for

which the holder may not recover substantially all of its initial investment,

other than because of credit deterioration, should be classified as availablefor-

sale. Loans and receivables are measured at amortised cost.

**Held-to-maturity investments** are non-derivative financial assets with fixed

or determinable payments that an entity intends and is able to hold to

maturity and that do not meet the definition of loans and receivables and are

not designated on initial recognition as assets at fair value through profit or

loss or as available for sale. Held-to-maturity investments are measured at

amortised cost. If an entity sells a held-to-maturity investment other than in

insignificant amounts or as a consequence of a non-recurring, isolated

event beyond its control that could not be reasonably anticipated, all of its

other held-to-maturity investments must be reclassified as available-for-sale

for the current and next two financial reporting years. Held-to-maturity

investments are measured at amortised cost.

***Classification of Financial Liabilities***

IAS 39 recognises two classes of financial liabilities:

Financial liabilities at fair value through profit or loss

Other financial liabilities measured at amortised cost using the

effective interest method

The category of financial liability at fair value through profit or loss has two

subcategories:

**Designated.** a financial liability that is designated by the entity as a

liability at fair value through profit or loss upon initial recognition

**Held for trading.** a financial liability classified as held for trading,

such as an obligation for securities borrowed in a short sale, which

have to be returned in the future

***Initial Recognition***

IAS 39 requires recognition of a financial asset or a financial liability when,

and only when, the entity becomes a party to the contractual provisions of

the instrument, subject to the following provisions in respect of regular way

purchases.

**Regular way purchases or sales of a financial asset.** A regular way

purchase or sale of financial assets is recognised and derecognised using

either trade date or settlement date accounting. The method used is to be

applied consistently for all purchases and sales of financial assets that

belong to the same category of financial asset as defined in IAS 39 (note

that for this purpose assets held for trading form a different category from

assets designated at fair value through profit or loss). The choice of method

is an accounting policy.

IAS 39 requires that all financial assets and all financial liabilities be

recognised on the balance sheet. That includes all derivatives. Historically,

in many parts of the world, derivatives have not been recognised on

company balance sheets. The argument has been that at the time the

derivative contract was entered into, there was no amount of cash or other

assets paid. Zero cost justified non-recognition, notwithstanding that as time

passes and the value of the underlying variable (rate, price, or index)

changes, the derivative has a positive (asset) or negative (liability) value.

***Initial Measurement***

Initially, financial assets and liabilities should be measured at fair value

(including transaction costs, for assets and liabilities not measured at fair

value through profit or loss).

*Measurement Subsequent to Initial Recognition*

Subsequently, financial assets and liabilities (including derivatives) should

be measured at fair value, with the following exceptions:

Loans and receivables, held-to-maturity investments, and nonderivative

financial liabilities should be measured at amortised cost

using the effective interest method.

Investments in equity instruments with no reliable fair value

measurement (and derivatives indexed to such equity instruments)

should be measured at cost.

Financial assets and liabilities that are designated as a hedged item

or hedging instrument are subject to measurement under the hedge

accounting requirements of the IAS 39.

Financial liabilities that arise when a transfer of a financial asset does

not qualify for de-recognition, or that are accounted for using the

continuing-involvement method, are subject to particular

measurement requirements.

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. IAS 39 provides a hierarchy to be used in determining the fair

value for a financial instrument:

Quoted market prices in an active market are the best evidence of

fair value and should be used, where they exist, to measure the

financial instrument.

If a market for a financial instrument is not active, an entity

establishes fair value by using a valuation technique that makes

maximum use of market inputs and includes recent arm's length

market transactions, reference to the current fair value of another

instrument that is substantially the same, discounted cash flow

analysis, and option pricing models. An acceptable valuation

technique incorporates all factors that market participants would

consider in setting a price and is consistent with accepted economic

methodologies for pricing financial instruments.

If there is no active market for an equity instrument and the range of

reasonable fair values is significant and these estimates cannot be

made reliably, then an entity must measure the equity instrument at

cost less impairment.

Amortised cost is calculated using the effective interest method. The

effective interest rate is the rate that exactly discounts estimated future cash

payments or receipts through the expected life of the financial instrument to

the net carrying amount of the financial asset or liability. Financial assets

that are not carried at fair value though profit and loss are subject to an

impairment test. If expected life cannot be determined reliably, then the

contractual life is used.

**IAS 39 Fair Value Option**

IAS 39 permits entities to designate, at the time of acquisition or issuance,

any financial asset or financial liability to be measured at fair value, with

value changes recognised in profit or loss. This option is available even if

the financial asset or financial liability would ordinarily, by its nature, be

measured at amortised cost – but only if fair value can be reliably

measured.

In June 2005 the IASB issued its amendment to IAS 39 to restrict the use of

the option to designate any financial asset or any financial liability to be

measured at fair value through profit and loss (the fair value option). The

revisions limit the use of the option to those financial instruments that meet

certain conditions:

the fair value option designation eliminates or significantly reduces an

accounting mismatch, or

a group of financial assets, financial liabilities or both is managed and

its performance is evaluated on a fair value basis by entity's

management.

Once an instrument is put in the fair-value-through-profit-and-loss category,

it cannot be reclassified out with some exceptions.

**IAS 39 Available for Sale Option for Loans and Receivables**

IAS 39 permits entities to designate, at the time of acquisition, any loan or

receivable as available for sale, in which case it is measured at fair value

with changes in fair value recognised in equity.

**Impairment**

A financial asset or group of assets is impaired, and impairment losses are

recognised, only if there is objective evidence as a result of one or more

events that occurred after the initial recognition of the asset. An entity is

required to assess at each balance sheet date whether there is any

objective evidence of impairment. If any such evidence exists, the entity is

required to do a detailed impairment calculation to determine whether an

impairment loss should be recognised. The amount of the loss is measured

as the difference between the asset's carrying amount and the present

value of estimated cash flows discounted at the financial asset's original

effective interest rate.

Assets that are individually assessed and for which no impairment exists are

grouped with financial assets with similar credit risk statistics and

collectively assessed for impairment.

If, in a subsequent period, the amount of the impairment loss relating to a

financial asset carried at amortised cost or a debt instrument carried as

available-for-sale decreases due to an event occurring after the impairment

was originally recognised, the previously recognised impairment loss is

reversed through profit or loss. Impairments relating to investments in

available-for-sale equity instruments are not reversed through profit or loss.

***De-recognition of a Financial Asset***

The basic premise for the de-recognition model in IAS 39 is to determine

whether the asset under consideration for de-recognition is:

an asset in its entirety or

specifically identified cash flows from an asset or

a fully proportionate share of the cash flows from an asset or

a fully proportionate share of specifically identified cash flows from a

financial asset

Once the asset under consideration for de-recognition has been

determined, an assessment is made as to whether the asset has been

transferred, and if so, whether the transfer of that asset is subsequently

eligible for de-recognition.

An asset is transferred if either the entity has transferred the contractual

rights to receive the cash flows, or the entity has retained the contractual

rights to receive the cash flows from the asset, but has assumed a

contractual obligation to pass those cash flows on under an arrangement

that meets the following three conditions:

the entity has no obligation to pay amounts to the eventual recipient

unless it collects equivalent amounts on the original asset

the entity is prohibited from selling or pledging the original asset

(other than as security to the eventual recipient),

the entity has an obligation to remit those cash flows without material

delay

Once an entity has determined that the asset has been transferred, it then

determines whether or not it has transferred substantially all of the risks and

rewards of ownership of the asset. If substantially all the risks and rewards

have been transferred, the asset is derecognised. If substantially all the

risks and rewards have been retained, de-recognition of the asset is

precluded.

If the entity has neither retained nor transferred substantially all of the risks

and rewards of the asset, then the entity must assess whether it has

relinquished control of the asset or not. If the entity does not control the

asset then de-recognition is appropriate; however if the entity has retained

control of the asset, then the entity continues to recognise the asset to the

extent to which it has a continuing involvement in the asset.

**De-recognition of a Financial Liability**

A financial liability should be removed from the balance sheet when, and

only when, it is extinguished, that is, when the obligation specified in the

contract is either discharged or cancelled or expires. [IAS 39.39] Where

there has been an exchange between an existing borrower and lender of

debt instruments with substantially different terms, or there has been a

substantial modification of the terms of an existing financial liability, this

transaction is accounted for as an extinguishment of the original financial

liability and the recognition of a new financial liability. A gain or loss from

extinguishment of the original financial liability is recognised in profit or loss.

[IAS 39.40-41]

**Hedge Accounting**

IAS 39 permits hedge accounting under certain circumstances provided that

the hedging relationship is:

formally designated and documented, including the entity's risk

management objective and strategy for undertaking the hedge,

identification of the hedging instrument, the hedged item, the nature

of the risk being hedged, and how the entity will assess the hedging

instrument's effectiveness and

expected to be highly effective in achieving offsetting changes in fair

value or cash flows attributable to the hedged risk as designated and

documented, and effectiveness can be reliably measured and

assessed on an ongoing basis and determined to have been highly

effective

**Hedging Instruments**

Hedging instrument is an instrument whose fair value or cash flows are

expected to offset changes in the fair value or cash flows of a designated

hedged item.

All derivative contracts with an external counterparty may be designated as

hedging instruments except for some written options. A non-derivative

financial asset or liability may not be designated as a hedging instrument

except as a hedge of foreign currency risk.

For hedge accounting purposes, only instruments that involve a party

external to the reporting entity can be designated as a hedging instrument.

This applies to intragroup transactions as well. However, they may qualify

for hedge accounting in individual financial statements.

**Hedged Items**

Hedged item is an item that exposes the entity to risk of changes in fair

value or future cash flows and is designated as being hedged. [IAS 39.9]

A hedged item can be:

a single recognised asset or liability, firm commitment, highly

probable transaction or a net investment in a foreign operation

a group of assets, liabilities, firm commitments, highly probable

forecast transactions or net investments in foreign operations with

similar risk characteristics

a held-to-maturity investment for foreign currency or credit risk

a portion of the cash flows or fair value of a financial asset or financial liability or

a non-financial item for foreign currency risk only for all risks of the

entire item

**Effectiveness**

IAS 39 requires hedge effectiveness to be assessed both prospectively and

retrospectively. To qualify for hedge accounting at the inception of a hedge

and, at a minimum, at each reporting date, the changes in the fair value or

cash flows of the hedged item attributable to the hedged risk must be

expected to be highly effective in offsetting the changes in the fair value or

cash flows of the hedging instrument on a prospective basis, and on a

retrospective basis where actual results are within a range of 80% to 125%.

All hedge ineffectiveness is recognised immediately in profit or loss

(including ineffectiveness within the 80% to 125% window).

**Categories of Hedges**

**A fair value hedge** is a hedge of the exposure to changes in fair value of a

recognised asset or liability or a previously unrecognised firm commitment

or an identified portion of such an asset, liability or firm commitment, that is

attributable to a particular risk and could affect profit or loss. The gain or

loss from the change in fair value of the hedging instrument is recognised

immediately in profit or loss. At the same time the carrying amount of the

hedged item is adjusted for the corresponding gain or loss with respect to

the hedged risk, which is also recognised immediately in net profit or loss.

**A cash flow hedge** is a hedge of the exposure to variability in cash flows

that (i) is attributable to a particular risk associated with a recognised asset

or liability (such as all or some future interest payments on variable rate

debt) or a highly probable forecast transaction and (ii) could affect profit or

loss. The portion of the gain or loss on the hedging instrument that is

determined to be an effective hedge is recognised in other comprehensive

income.

If a hedge of a forecast transaction subsequently results in the recognition

of a financial asset or a financial liability, any gain or loss on the hedging

instrument that was previously recognised directly in equity is 'recycled' into

profit or loss in the same period(s) in which the financial asset or liability

affects profit or loss.

If a hedge of a forecast transaction subsequently results in the recognition

of a non-financial asset or non-financial liability, then the entity has an

accounting policy option that must be applied to all such hedges of forecast

transactions:

Same accounting as for recognition of a financial asset or financial liability - any gain or loss on the hedging instrument that was previously recognised in other comprehensive income is 'recycled' into profit or loss in the same period(s) in which the non-financial

asset or liability affects profit or loss.

'Basis adjustment' of the acquired non-financial asset or liability - the

gain or loss on the hedging instrument that was previously

recognised in other comprehensive incomeis removed from equity

and is included in the initial cost or other carrying amount of the

acquired non-financial asset or liability.

**A hedge of a net investment in a foreign operation** as defined in IAS 21

is accounted for similarly to a cash flow hedge.

**A hedge of the foreign currency risk of a firm commitment** may be

accounted for as a fair value hedge or as a cash flow hedge.

**Discontinuation of Hedge Accounting**

Hedge accounting must be discontinued prospectively if:

the hedging instrument expires or is sold, terminated, or exercised

the hedge no longer meets the hedge accounting criteria – for

example it is no longer effective

for cash flow hedges the forecast transaction is no longer expected to

occur, or

the entity revokes the hedge designation

For the purpose of measuring the carrying amount of the hedged item when

fair value hedge accounting ceases, a revised effective interest rate is

calculated.

If hedge accounting ceases for a cash flow hedge relationship because the

forecast transaction is no longer expected to occur, gains and losses

deferred in other comprehensive income must be taken to profit or loss

immediately. If the transaction is still expected to occur and the hedge

relationship ceases, the amounts accumulated in equity will be retained in

equity until the hedged item affects profit or loss. [IAS 39.101(c)]

If a hedged financial instrument that is measured at amortised cost has

been adjusted for the gain or loss attributable to the hedged risk in a fair

value hedge, this adjustment is amortised to profit or loss based on a

recalculated effective interest rate on this date such that the adjustment is

fully amortised by the maturity of the instrument. Amortisation may begin as

soon as an adjustment exists and must begin no later than when the

hedged item ceases to be adjusted for changes in its fair value attributable

to the risks being hedged.

**Example 1**

On 2 January 2009, a company buys $100,000 of 6% loan stock for

$93,930. Interest will be received on 31 December each year and the stock

will be redeemed at par on 31 December 2013. The company intends to

hold the stock until maturity and calculates the effective interest rate to be

7.5% per annum. Financial statements are prepared to 31 December each

year.

a) The loan stock is measured initially at $93,930.

b) The amortised cost of the loan stock at the end of each year is

calculated as follows:

*Year Balance Interest Amount Amortised*

*b/f @ 7.5% received cost*

$ $ $ $

2009 93,930 7,045 (6,000) 94,975

2010 94,975 7,123 (6,000) 96,098

2011 96,098 7,207 (6,000) 97,305

2012 97,305 7,298 (6,000) 98,603

2013 98,603 7,397 (106,000) 0

36,070

*Notes:*

*i)* The interest earned each year is 7.5% of the balance brought

forward. This is recognised as income in the company’s financial

statements. Interest at 7.5% for 2013 would in fact be $7,395 but this

has been adjusted to $7,397 to ensure that the balance remaining at

the end of the year is $nil. It would appear that the effective rate of

interest is actually very slightly more than 7.5%.

*ii)* The effective interest rate (7.5% is higher than the rate (6%) at which

annual interest payments are calculated because the company will

receive a premium of $6,070 ($100,000 - $93,930) when the loan

stock is redeemed. The effective interest method spreads this

premium fairly over the life of the loan stock.

*iii)* Total income is $36,070. This amount is equal to annual interest of

$6,000 for five years plus the premium of $6,070.

c) If the amounts receivable during the life of the loan stock are discounted

at an annual rate of 7.5%, the present value of each amount is as

follows:

Workings

Present Value

$

Receivable 31 December 2009 $6,000 ÷ 1.075 5,581

Receivable 31 December 2010 $6,000 ÷ (1.075)² 5,192

Receivable 31 December 2011 $6,000 ÷ (1.075)³ 4,830

Receivable 31 December 2012 $6,000 ÷ (1.075)4 4,493

Receivable 31 December 2013 $106,000 ÷ (1.075)5 73,835

93,931

Apart from a small rounding difference, an effective rate of 7.5% does

indeed discount estimated future cash receipts to the initial carrying

amount of $93,930.

**Question 1**

Company A is evaluating whether each of these items is a financial

instrument and whether it should be accounted for under IAS 32:

(a) Cash deposited in banks

(b) Gold bullion deposited in banks

(c) Trade accounts receivable

(d) Investments in debt instruments

(e) Investments in equity instruments, where Company A does not have

significant influence over the investee

(f) Investments in equity instruments, where Company A has significant

influence over the investee

(g) Prepaid expenses

(h) Finance lease receivables or payables

(i) Deferred revenue

(j) Statutory tax liabilities

(k) Provision for estimated litigation losses

(l) An electricity purchase contract that can be net settled in cash

(m) Issued debt instruments

**(n)** Issued equity instruments

**Question 2**

During 2004, Entity A has issued a number of financial instruments. It is

evaluating how each of these instruments should be presented under IAS 32:

(a) A perpetual bond (i.e., a bond that does not have a maturity date) that

pays 5% interest each year

(b) A mandatorily redeemable share with a fixed redemption amount (i.e., a

share that will be redeemed by the entity at a future date)

(c) A share that is redeemable at the option of the holder for a fixed amount of

cash

(d) A sold (written) call option that allows the holder to purchase a fixed

number of ordinary shares from Entity A for a fixed amount of cash

For each of the above instruments, discuss whether it should be classified as a

financial liability and, if so, why.

**Question 3**

Which of the following assets is not a financial asset?

A Cash.

B An equity instrument of another entity.

C A contract that may or will be settled in the entity's own equity

instrument and is not classified as an equity instrument of the entity.

D Prepaid expenses.

**Question 4**

Which of the following liabilities is a financial liability?

A Deferred revenue.

B A warranty obligation.

C A constructive obligation.

D An obligation to deliver own shares worth a fixed amount of cash.

**Question 5**

A company has a building under construction that is being financed with

$8 million of debt, $6 million of which is a construction loan directly on the

building. The rest is financed out of the general debt of the company. The

company will use the building when it is completed. The debt structure of

the firm is as follows:

Construction loan @ 11 % $6M

Long-term debentures @ 9% $9M

Long-term subordinated debentures @ 10% $3M

What amount of interest expense should be reported on the income

statement?

A $920,000

B $1,140,000

C $925,000

D $1,770,000

**Question 6**

On 1 January 2009, a company issues $200,000 of 7% loan stock at par. Interest on

this loan stock is payable on 31 December each year. The stock is due for

redemption at par on 31 December 2012 but may be converted into ordinary shares

on that date instead.

Assuming that the market rate of interest to be used in discounted cash flow

calculations is 9% p.a., calculate the liability component and the equity component of

this loan stock.

**Question7**

On 1 July 2009, a company issues $1 million of 8% loan stock. The stock is issued

at a 10% discount (so only $900,000 is received from the lenders) and issue costs of

$39,300 are incurred. Interest is payable in arrears on 30 June each year and the

loan stock is redeemable at par on 30 June 2012. The effective interest rate is

calculated to be 14% per annum. The company prepares financial statements to 30

June each year.

State the amount at which this loan stock should be measured on 1 July 2009.

Calculate the amount at which the loan stock should be measured on 30 June 2010,

2011 and 2012

***IFRS 9 Replacing IAS 39***

**Recognition and measurement**

This standard introduces new requirements for the classification and measurement

of financial assets and is effective from 1 January 2013, with early adoption

permitted. New requirements for classification and measurement of financial

liabilities, de-recognition of financial instruments, impairment and hedge accounting

are to be added to IFRS 9 in 2010. Early adoption of the standard is a major step for

any entity, because an early adopter of IFRS 9 continues to apply IAS 39 for other

accounting requirements for financial instruments that are not covered by IFRS 9,

that is classification and measurement of financial liabilities, recognition and derecognition of financial assets and financial liabilities, impairment of financial assets

and hedge accounting. In some jurisdictions, the new standards will have to be

adopted before they can be applied, and in others there will be some restrictions on

early adoption. It would seem wise to wait until the whole of the new standard has

been finalised.

The standard retains a mixed-measurement model, with some assets measured at

amortised cost and others at fair value. The distinction between the two models is

based on the business model of each entity and a requirement to assess whether

the cashflows of the instrument are only principal and interest. The business-model

approach is fundamental to the standard, and is an attempt to align the accounting

with the way in which management uses its assets in its business while also looking

at the characteristics of the business. A debt instrument generally must be measured

at amortised cost if both the 'business model test' and the 'contractual cash flow

characteristics test' are satisfied. The business model test is whether the objective of

the entity's business model is to hold the financial asset to collect the contractual

cashflows rather than have the objective to sell the instrument before its contractual

maturity to realise its fair value changes.

The contractual cashflow characteristics test is whether the contractual terms of the

financial asset give rise, on specified dates, to cashflows that are solely payments of

principal and interest on the principal amount outstanding.

All recognised financial assets that are in the scope of IAS 39 will be measured at

either amortised cost or fair value. The standard contains only the two primary

measurement categories for financial assets, unlike IAS 39 where there were

multiple measurement categories. Thus the existing IAS 39 categories of held to

maturity, loans and receivables and available for sale are eliminated, as are the

tainting provisions of the standard.

A debt instrument, such as a loan receivable, that is held within a business model

whose objective is to collect the contractual cashflows and has contractual cashflows

that are solely payments of principal and interest generally must be measured at

amortised cost. All other debt instruments must be measured at fair value through

profit or loss (FVTPL). An investment in a convertible loan note would not qualify for

measurement at amortised cost because of the inclusion of the conversion option,

which is not deemed to represent payments of principal and interest. This criterion

will permit amortised cost measurement when the cashflows on a loan are entirely

fixed, such as a fixed-interest-rate loan or where interest is floating or a combination

of fixed and floating interest rates.

IFRS 9 contains an option to classify financial assets that meet the amortised cost

criteria as at FVTPL if doing so eliminates or reduces an accounting mismatch. An

example of this may be where an entity holds a fixed-rate loan receivable that it

hedges with an interest rate swap that changes the fixed rates for floating rates.

Measuring the loan asset at amortised cost would create a measurement mismatch,

as the interest rate swap would be held at FVTPL. In this case, the loan receivable

could be designated at FVTPL under the fair value option to reduce the accounting

mismatch that arises from measuring the loan at amortised cost.

**Gains and losses**

All equity investments within the scope of IFRS 9 are to be measured in the

statement of financial position at fair value with the default recognition of gains and

losses in profit or loss. Only if the equity investment is not held for trading can an

irrevocable election be made at initial recognition to measure it at fair value through

other comprehensive income (FVTOCI) with only dividend income recognised in

profit or loss. The amounts recognised in other comprehensive income (OCI) are not

recycled to profit or loss on disposal of the investment although they may be

reclassified in equity.

The standard eliminates the exemption allowing some unquoted equity instruments

and related derivative assets to be measured at cost. However it includes guidance

on the rare circumstances where the cost of such an instrument may be appropriate

estimate of fair value.

The classification of an instrument is determined on initial recognition and

reclassifications are only permitted on the change of an entity's business model and

are expected to occur only infrequently. An example of where reclassification from

amortised cost to fair value might be required would be when an entity decides to

close its mortgage business, no longer accepting new business, and is actively

marketing its mortgage portfolio for sale.

When a reclassification is required it is applied from first day of the first reporting

period following the change in business model.

All derivatives within the scope of IFRS 9 are required to be measured at fair value.

IFRS 9 does not retain IAS 39's approach to accounting for embedded derivatives.

Consequently, embedded derivatives that would have been separately accounted for

at FVTPL under IAS 39 because they were not closely related to the financial asset

host will no longer be separated. Instead, the contractual cash flows of the financial

asset are assessed as a whole and are measured at FVTPL if any of its cashflows

do not represent payments of principal and interest.

A frequent question is whether IFRS 9 will result in more financial assets being

measured at fair value. It will depend on the circumstances of each entity in terms of

the way it manages the instruments it holds, the nature of those instruments and the

classification elections it makes. One of the most significant changes will be the

ability to measure some debt instruments, such as investments in government and

corporate bonds, at amortised cost. Many available-for-sale debt instruments

measured at fair value will qualify for amortised cost accounting.

Many loans and receivables and held to maturity investments will continue to be

measured at amortised cost but some will have to be measured at FVTPL. For

example, some instruments, such as cash-collateralised debt obligations, that may

under IAS 39 have been measured entirely at amortised cost or as available-for-sale,

will more likely be measured at FVTPL.

**Measured in entirety**

Some financial assets that are currently disaggregated into host financial assets that

are not at FVTPL will instead by measured at FVTPL in their entirety. Assets that are

classified as held-to-maturity are likely to continue to be measured at amortised cost

as they are held to collect the contractual cash flows and often give rise to only

payments of principal and interest.

IFRS 9 does not address impairment. However as IFRS 9 eliminates the available

for sale (AFS) category, it also eliminates the AFS impairment rules. Under IAS 39

measuring impairment losses on debt securities in illiquid markets based on fair

value often led to reporting an impairment loss that exceeded the credit loss

management expected. Additionally, impairment losses on AFS equity investments

cannot be reversed under IAS 39 if the fair value of the investment increases. Under

IFRS 9, debt securities that qualify for the amortised cost model are measured under

that model and declines in equity investments measured at FVTPL are recognised in

profit or loss and reversed through profit or loss if the fair value increases.

The aim of the revision of IAS 39 is to remove inconsistencies between US GAAP

and IFRS in accounting for financial instruments. This will enable easy comparisons

to be made between entities applying IFRSs and those using US GAAP. IFRS 9 was

a first step in this direction. In order to work towards convergence of their

requirements both the IASB and the US Financial Accounting Standards Board

(FASB) are reconsidering the financial instruments standards.