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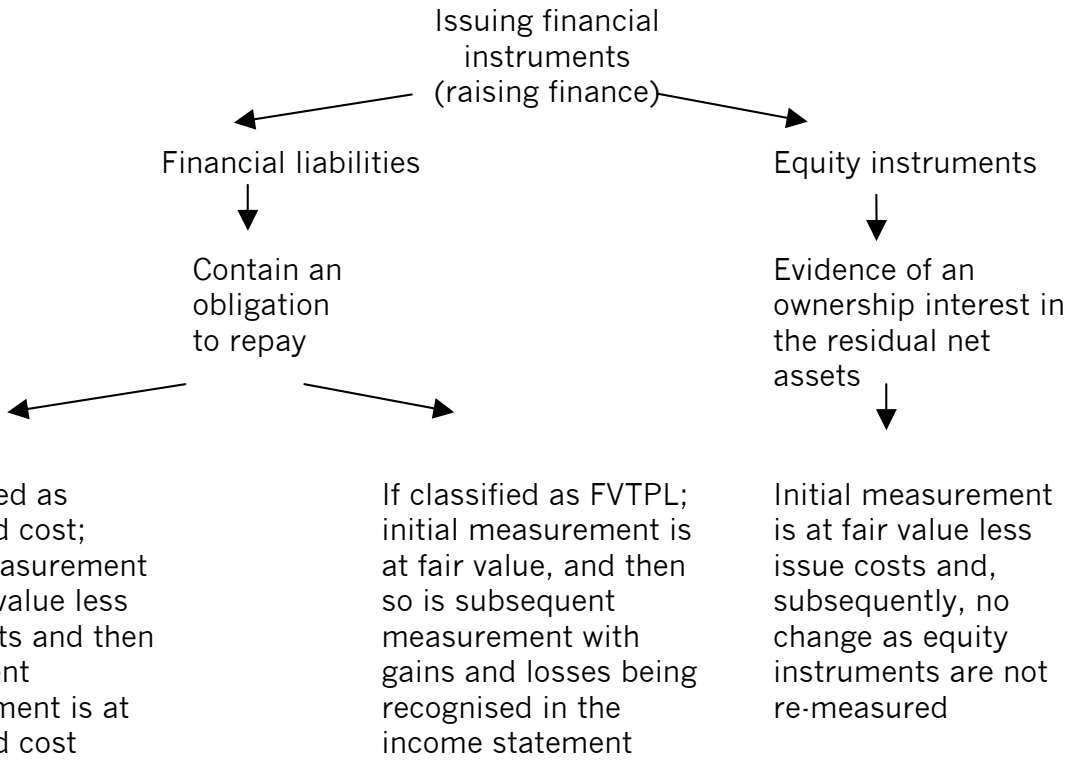
What is a financial instrument? Part 2

My previous article covered the classification, initial measurement and subsequent measurement of financial liabilities (eg loans and bonds) and issued equity instruments (eg ordinary shares). It was established that when issuing financial instruments to raise finance, the issuer had to classify instrument as either financial liabilities (and, in turn, financial liabilities were split into amortised cost and Fair Value Through Profit or Loss (FVTPL)) or equity instruments. This can be summarised in the following diagram.



Accounting for compound financial instruments

While the vast majority of financial instruments create a financial asset in one entity and a financial liability *or* equity instrument in the accounts of another entity, it is possible that a single financial instrument can create a financial asset in one entity and a financial liability ***and*** an equity instrument in another entity. The classic example of this arises when an entity issues a convertible bond.

Accounting for the issue of convertible bonds (debt and equity in a single instrument)

Convertible bonds are basically debt instruments but they also contain an option to convert into equity shares and this means that a convertible bond contains both debt and equity elements. The option to convert into equity is strictly a derivative that is embedded into the host contract. The option will be exercisable by the holder of the bond who has the option to require settlement of the debt in equity shares rather than

being repaid in cash. For accounting purposes it will be necessary on initial recognition to split out the debt and equity elements so that they can be separately accounted for. The fair value of the option is highly subjective, but the fair value of the debt element is more easily measured by discounting the future cash flows. The assumption is then made that the fair value of the option is the balancing figure.

Example 1
Graham Gooch issues a 3% $200,000 two-year convertible bond at par. The effective rate of interest of the instrument is 8%. The terms of the convertible bond is that the holder of the bond, on the redemption date, has the option to convert the bond to equity shares at the rate of 10 shares with a nominal value of $1 per $100 debt rather than being repaid in cash. Transaction costs can be ignored. Graham Gooch will account for the financial liability arising using amortised cost.

Required
Explain the accounting for the issue of the convertible bond.

Solution
A convertible bond creates both an equity and a debt instrument. On initial recognition the debt element will be measured at fair value – ie the present value of the future cash flow, with the equity element representing the balancing figure. Transaction costs have been ignored, but would have to split proportionately between the debt and equity elements. The value ascribed to the equity element is the balancing figure.

	Cash flow (3% x $200,000)	**Discount factor @ 8%**	**Present value of the future cash flow**
Year 1	$6,000	X 0.926	$5,556
Year 2	$206,000	X 0.857	$176,542
Fair value of the debt element			$182,098
Fair value of the equity element (balancing figure)			$17,902
Proceeds of the issue			$200,000

In journal entry terms the initial issue of the convertible bond can be summarised as follows:

Dr	Cash	$200,000	
Cr	Financial liability		$182,098
Cr	Equity		$17,902

The Cr to equity can be reported in a reserve entitled 'Other components of equity'. Equity is not subsequently remeasured. The liability on the other hand will be accounted for using amortised cost charging income with a finance cost at the rate of 8%.

	Opening balance	Income statement finance cost@8%	Less cash	Closing balance of the liability
Year 1	$182,098	$14,568	($6,000)	$190,666
Year 2	$190,666	$15,334*	($6,000)	$200,000

**includes rounding*

At the end of Year 2 the liability can be extinguished by the payment of $200,000 in cash, or if the option is exercised by the bond holder, then it is extinguished by the issue of 20,000 $1 ordinary shares at nominal value with a share premium of $180,000 also being recorded.

Financial assets

Now let us turn our attention to the accounting for financial assets, as there have been some recent changes following the issue of IFRS 9, *Financial Instruments* which will supersede IAS 39, *Financial Instruments: Recognition and Measurement*. The new standard applies to all types of financial assets, except for investments in subsidiaries, associates and joint ventures and pension schemes, as these are all accounted for under various other accounting standards.

IFRS 9, *Financial Instruments* has simplified the way that financial assets are accounted. As with financial liabilities the standard retains a mixed measurement system for financial assets, allowing some to be stated at fair value while others at amortised cost. On the same basis that when an entity issues a financial instrument it has to classify it as a financial liability or equity instrument, so when an entity acquires a financial asset it will be acquiring a debt asset (eg an investment in bonds, trade receivables) or an equity asset (eg an investment in ordinary shares). Financial assets have to be classified and accounted for in one of three categories: amortised cost, FVTPL or Fair Value Through Other Comprehensive Income (FVTOCI). They are initially measured at fair value plus, in the case of a financial asset not at FVTPL, transaction costs.

Accounting for financial assets that are debt instruments

A financial asset that is a debt instrument will be subsequently accounted for using amortised cost if it meets two simple tests. These two tests are the business model test and the cash flow test.

The business model test is met where the purpose is to hold the asset to collect the contractual cash flows (rather than to sell it prior to maturity to realise its fair value changes). The cash flow test will be met when the contractual terms of the asset give rise on specified dates to cash flows that are solely receipts of either the principal or interest.

These tests are designed to ensure that the fair value of the asset is irrelevant, as even if interest rates fall – causing the fair value to raise – then the asset will still be passively held to receive interest and capital and not be sold on.

However, even if the asset meets the two tests there is still a fair value option to designate it as FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (an 'accounting mismatch') that would otherwise arise from

measuring assets or liabilities or recognising the gains and losses on them on different bases. An example of where it is appropriate to use the fair value option and, thus, avoid an accounting mismatch is where an entity holds a financial asset that is debt and that carries a fixed rate of interest, but is then hedged with an interest rate swap that swaps the fixed rates for floating rates. The interest swap is a financial instrument that would be held at FVTPL and so, accordingly, the financial asset classified as debt also needs to be at FVTPL to ensure that the gains and losses arising from both instruments are naturally paired in income and, thus, reflect the substance of the hedge. If the financial asset classified as debt was accounted for at amortised cost, then this would create the accounting mismatch.

All other financial assets that are debt instruments must be measured at FVTPL.

Accounting for financial assets that are equity instruments (eg investments in equity shares)

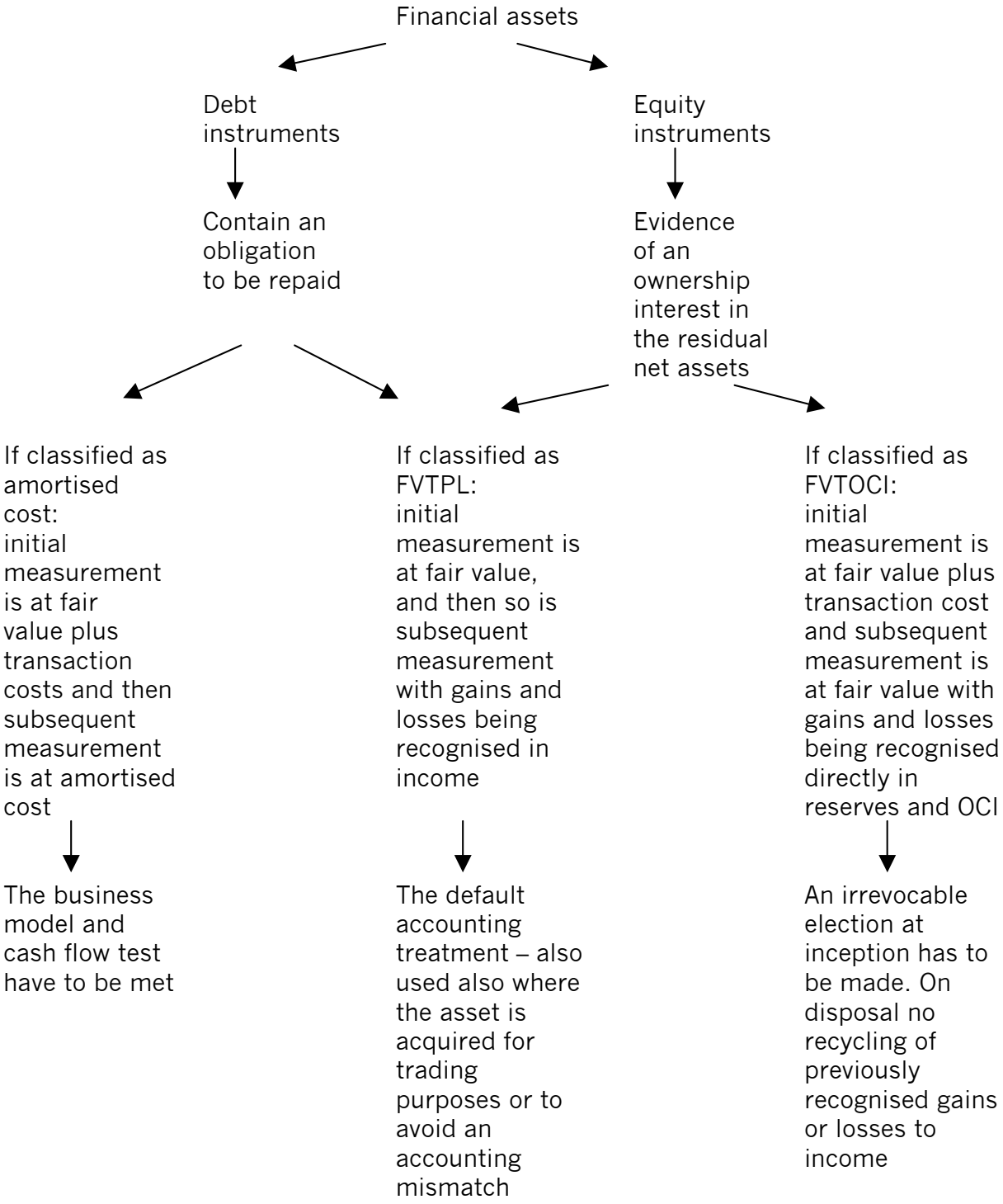
Equity investments have to be measured at fair value in the statement of financial position. As with financial assets that are debt instruments, the default position for equity investments is that the gains and losses arising are recognised in income (FVTPL). However, there is an election that equity investments can at inception be irrevocably classified and accounted as FVTOCI, so that gains and losses arising are recognised in other comprehensive income, thus creating an equity reserve, while dividend income is still recognised in income. Such an election cannot be made if the equity investment is acquired for trading. On disposal of an equity investment accounted for as FVTOCI, the gain or loss to be recognised in income is the difference between the sale proceeds and the carrying value. Gains or losses previously recognised in other comprehensive income cannot be recycled to income as part of the gain on disposal.

For example, let us consider the case of an equity investment accounted for at FVTOCI that was acquired several years ago for $10,000 and by the last reporting date has been revalued to $30,000. If the asset is then sold for $31,000, the gain on disposal to be recognised in the income statement is only $1,000 as the previous gain of $20,000 has already been recognised and reported in the other comprehensive income statement. IFRS 9 requires that gains can only be recognised once. The balance of $20,000 in the equity reserves that relates to the equity investment can be transferred into retained earnings as a movement within reserves.

The accounting for financial assets can be summarised in the diagram on the following page.

Reclassification of financial assets

As we have seen once an equity investment has been classified as FVTOCI this is irrevocable so it cannot then be reclassified. Nor can a financial asset be reclassified where the fair value option has been exercised. However if, and only if the entity's business model objective for its financial assets changes so its previous model assessment would no longer apply then other financial assets can be reclassified between FVTPL and amortised cost, or vice versa. Any reclassification is done prospectively from the reclassification date without restating any previously recognised gains, losses, or interest.



Accounting for impairment losses on financial assets

Under the suggested new requirements of IFRS 9, *Financial Instruments*, only financial assets measured at amortised cost will be subject to impairment reviews. It is also proposed that an expected loss model towards impairment reviews be introduced when reviewing these financial assets. The expected loss model requires that entities

determine and account for expected credit losses when the asset is originated or acquired rather than wait for an actual default. This is achieved by making an allowance for the initial expected losses over the life of the asset by considering a reduction in the interest revenue.

Example 2: accounting for impairment losses
Imran Khan holds a portfolio of financial assets that are debt instruments (ie Imran Khan is a lender). These assets are initially recognised at $100,000 and accounted for at amortised cost as they meet the business model and cash flow tests. Each loan has a coupon rate of 8% as well as an effective rate of 8%. In the current period no loans have actually defaulted; however, it is felt that a proportion of loans will default over the loan period and, thus, in the long run the rate of return from the portfolio will be approximately 3%.

Required
Discuss the impairment review of these assets in the first accounting period using the expected loss model.

Solution
The gross interest income that is initially recognised in income is $8,000 (as calculated using the effective rate of 8% on the initial carrying value of $100,000). With no defaults, cash of $8,000 will also be received (as calculated using the coupon rate of 8% on the nominal value). Thus, prior to any impairment review the carrying value at the end of the first reporting period is $100,000.

However, to recognise the impairment loss on an expected loss basis the actual net rate of return inclusive of expected defaults of 3% has to be considered. This gives a net $3,000 (3% x $100,000) to be recognised in income. Thus, there is an expected loss adjustment of $5,000 ($8,000 less $3,000) leaving the asset written down to $95,000 ($100,000 less $5,000).

Historically impairment reviews had been accounted using an incurred loss model – ie in order to recognise an impairment loss, there had first to be a specific past event indicating an impairment. In the above example, on this basis no allowance would have been made of the expected future losses so that the interest income recognised would be simply $8,000 and the asset stated at $100,000.

The incurred loss model led to the failure of lenders to recognise what were arguably known losses and to overstate assets. The new approach of measuring impairment on an expected loss model is both in accordance with prudence, in that losses are anticipated and accruals in that the losses are in effect spread over the period of the life of the asset and not back loaded.

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