CIMA

Chartered Institute of
Management Accountants

Accounting standard study group

CIMA Sri Lanka Division

Study of LKAS 32: financial instruments - presentation and LKAS 39: financial instruments - recognition and measurement

1. Objective and scope

Objective: Establish principles for the presentation, categorisation, recognition and measurement of financial instruments in the financial reports.

Scope: Both LKAS 32 and 39 shall be applied by all entities to all types of financial instruments except those addressed by other standards such as the following.

- Interests in subsidiaries, associates or joint ventures (LKAS 27, 28 and 31)
- Employees' rights and obligation under the employees benefit plan (LKAS 19)
- Insurance contracts, and contracts that are within the scope of SLFRS 4
- Rights and obligations under the leases (LKAS 17)
- Financial instruments, contracts and obligation under the share based payments (SLFRS 2)

In certain situations however LKAS 39 may still be applicable for transactions relating to the above, such as embedded derivatives in insurance contracts.

2. Executive summary

LKAS 32 and LKAS 39 give detailed descriptions of the accounting treatment and presentation of financial instruments, with an implementation date of 1 January 2012. The application of these two standards consistently in organisations will be a major challenge for both the management of the organisation (in terms of reporting) as well as the regulators (in terms of monitoring), and a clear understanding of the standard is imperative to enable a relatively seamless transition. On a global perspective IAS 39 has been superseded with the introduction of IFRS 9, although its implementation in Sri Lanka is not in the immediate horizon. Multinationals who may adopt IFRS 9 on a global reporting perspective, may still have to adopt LKAS 39 for local reporting, unless otherwise early adoption of IFRS 9 is allowed locally.

This document is presented as an initial overview of the two standards and does not aim to answer all of the questions that may arise in terms of complexities. For example, LKAS 39 gives guidelines to the application of the concept of hedge accounting, which has been excluded for the purpose of this initial study. The disclosure requirements for financial instruments, under SLFRS 7 have also been excluded from this study. Further studies will be done in terms of the more complex aspects surrounding the application of LKAS 32 and LKAS 39.

3. Key definitions

Financial instruments: Any contract that gives rise to:

A **financial asset** in one enterprise

and

A **financial liability** or **equity** instrument in another enterprise

Any **asset** that is:

- cash
- an equity instrument of another entity
- a contractual right:
  a. to receive cash or another financial asset from another entity or,
  b. to exchange financial asset or financial liability with another entity (with conditions)
- a contract that will or may be settled in the entity's own equity instruments.

Any **liability** that is:

- a contract obligation:
  a. to deliver cash or another financial asset to another entity
  b. to exchange financial assets or financial liabilities with another entity
- a contract that will or may be settled in the entity's own equity instruments.

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

What is a **contract** in the above definition? It is an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. This may take a variety of forms and need not be in writing.

Examples

- Is gold a financial asset? No, because it doesn't satisfy any of the above criteria's defined despite having a market value. i.e. it is not cash, an equity instrument or a contract.
- Are prepayments a financial asset? No, because it is not a contractual right to receive cash/another financial asset. It is merely a right to receive a service.
- Is a commercial paper a financial asset? Yes, because it's a contract to deliver/receive cash.

Derivative: Is a financial instrument or other contract with all three of the following characteristics.

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices/rates etc.
- It requires little/no initial investment
- It is settled at a future date (i.e. it is net settled in the future)

A derivative effectively transfers the risk inherent in an underlying primary instrument between the contracting parties **without** any need to transfer the underlying instruments themselves.

4. Classification and presentation

An instrument is classified as liability or equity based on the substance of the contractual arrangement rather than its legal form.

The entity must make the decision at the time the instrument is initially recognised. The classification is not subsequently changed based on changed circumstances. A financial instrument is an equity instrument only if it satisfies the following criteria.

- The instrument includes no contractual obligation to deliver cash or another financial asset to another entity or exchange financial assets and financial liabilities with another entity that are potentially unfavourable to the issuer.
- The instrument will or may be settled in the issuer's own equity instrument.

Examples

- Can preference shares be considered as liabilities? Yes, if it is mandatory redeemable shares or gives the holder the right to require the issuer to redeem the instrument on or after a particular date for a fixed or determinable amount.
- Preference dividends will be considered dividends though (and not interest), since it will be at the management discretion.
- Convertible debentures – accounted for upfront separately for the debt and equity components, as opposed to date of conversion.

If an entity re-acquires its own equity instruments, those instruments (treasury shares) shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, issue, or cancellation of an entity's own equity instruments.

A financial asset and financial liability shall be off set when an entity:

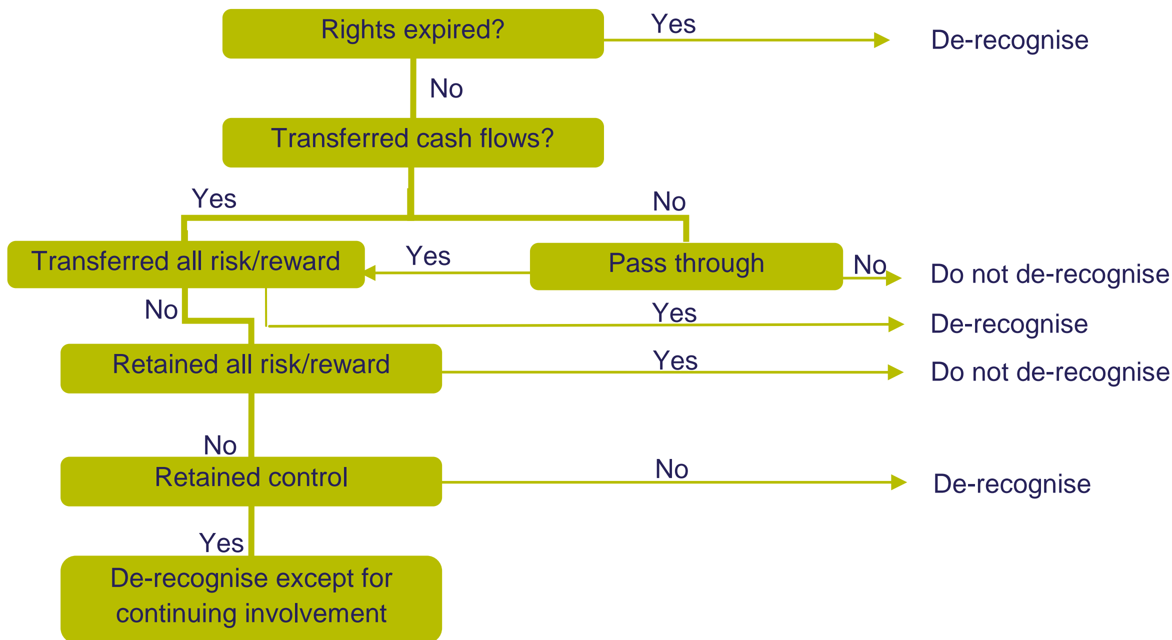
a. currently has a legally enforceable right to set off the recognised amount; and
b. intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Management considerations

- Debt vs. equity classification will affect the capital structure of the organisation, and this in turn will affect the P&L representation. For example, classifying an equity instrument as debt would result in the corresponding expenditure being recorded as interest as opposed to dividends.
- This will have an impact on performance ratios such as return on equity (ROE), return on assets (ROA) as well as capital/equity ratios such as earnings per share (EPS). Hence, this will have an impact when structuring facilities.
- Since there will be a certain element of judgement to be applied, this can cause problems for management in terms of identifying which approach to take for the different situations.
- Peer comparison between companies will be difficult since different applications of the above concept can result in different views being taken on the respective companies.
- Terms and conditions of the respective financial instruments are important to classify any liability vs. equity.
- Recording under fair value can create balance sheet volatility, and hence financial indicators such as Debt: Equity ratios can get affected, which can once again have an impact on structuring arrangements.
- Employee incentives can get affected if those incentives are based on profits, and profits get affected based on the respective classification.

5. Recognition and de-recognition

- An entity shall recognise a financial asset or a liability in its statement of financial position only when the entity becomes a party to the contractual provisions of the instrument.
- De-recognition testing is first applied to consolidated position. Why is it? To check on special purpose vehicles (SPV) and avoid transferring instruments to non-earning assets or off-balance sheet items.
- Is de-recognition applied to whole instrument or part of the instrument? Whole instrument unless the part comprises of specifically identified cash flows or a fully proportionate share of cash flows from a financial asset. For example, sub-participation of debt, losses being shared. Thereafter, the following flow chart can be used.



Management considerations

- Management accountants may not now be able to re-structure deals to derecognise assets with the aim of restructuring the balance sheet.

6. Measurement

Classification	Instrument	Balance sheet	Fair value gains and losses	Interest and dividends	Impairment	Reversal of impairment
At fair value through P&L /held-for-trading	Debt, equity or derivatives	Fair value	P&L	P&L	-	-
	Hybrid instruments	Cost	-	P&L	P&L (assets)	Cannot be reversed
Held-to-maturity	Debt	Amortised cost	-	P&L (effective interest rate)	P&L	P&L
Loans and receivables	Debt	Amortised cost	-	P&L (effective interest rate)	P&L	P&L
Available-for-sale financial assets	Debt	Fair value	Equity	P&L (effective interest rate)	P&L	P&L
	Equity	Fair value	Equity	P&L	P&L	Cannot be reversed through P&L
	Equity (not reliably measured)	Cost	-	P&L	P&L	Cannot be reversed
Other liabilities	Debt	Amortised cost	-	P&L (effective interest rate)	-	-

Management considerations

- First time adoption of these standards can have capital implications.
- Employee benefits such as below market loans (example: staff loans) need to be accounted at fair value. This will affect cost structure of the organisation.

Impairment

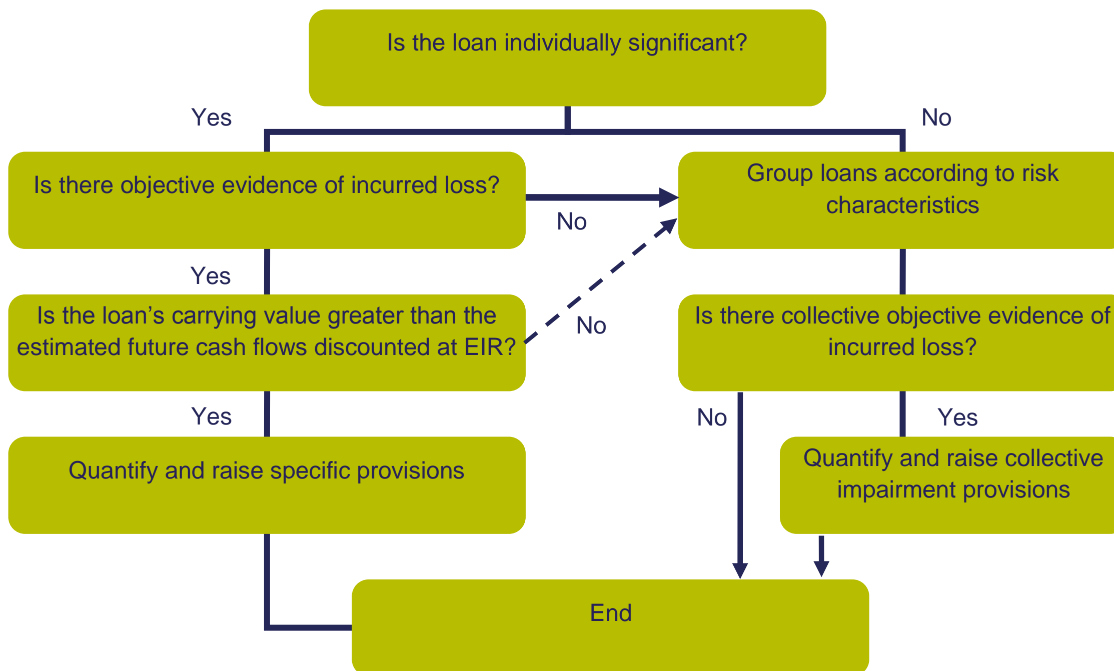
A financial asset (or a group of financial assets) is impaired only if:

- there is objective evidence of impairment at balance sheet date, after the initial measurement of asset(s), and
- the loss event has an impact on the estimated cash flows of the financial asset(s) (i.e. the carrying amount is greater than the estimated recoverable amount).

Objective evidence is where there is, for example:

- significant financial difficulty of issuer or obligator
- a breach of contract
- the lender granting a concession to the borrower (due to borrower's financial difficulty)
- probability of the borrower's bankruptcy or financial re-organisation
- the disappearance of an active market for the financial asset.

Hence, the first step is to identify conditions of impairment. Impairment testing is only done if there is a condition.



Impairment brings in an element of IBNR (incurred but not reported) because impairment is taken in much earlier than realised.

Examples

- If the owner of a company passes away, but the company has cash to pay for a further few months, when is impairment testing done? Testing is done on day one.
- Loans will need to be grouped as per risk characteristics, such as agriculture sector, tourism sector etc.
- Individual loans will need to be discounted at contracted rates and not market rates – if the rate was floating it would be fixed as at date of impairment.

Management considerations

- The impairment testing could result in an increase in the specific loan loss allowances, which would have a resulting impact on profitability and profitability ratios.
- Subjectivity of provisional amounts still remains due to usage of estimated cash flows and on the calculations itself (collective impairment vs. individual testing).
- The adoption of impairment testing could accelerate provisioning.
- Provisioning when net of security – security at future value (example: market value) but discounted at contractual rate.
- Values will consider both the estimated future cash flows plus the execution of any collateral.

Disclaimer

This document is compiled with the objective of presenting a basic overview of the respective Sri Lanka accounting standard, and does not construe professional advice in application of the standard. For specific application and understanding of all facets of the standard, the relevant Sri Lanka accounting standard issued by The Institute of Chartered Accountants of Sri Lanka should be referred.

Useful web-links pertaining to accounting standards

http://www.cimaglobal.com/Thought-leadership/Research-topics/Financial-reporting/CIMA-Sri-Lanka-accounting-standard-study-group/
http://www.ifrs.org/Home.htm
http://www.iasplus.com/standard/ias32.htm
http://www.iasplus.com/standard/ias39.htm
http://www.icasrilanka.com/Technical/Accounting%20Standards.html?bcsi_scan_ECD903E68216D30C=0&bcsi_scan_filename=Accounting%20Standards.html
http://accounting-financial-tax.com/ifrs/ifrs-chapters/ifrs-7-ias-32-and-39-financial-instruments/

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