

Avoiding the traps

A CFO's guide to dealing with financial instruments under IAS 32 and IAS 39

IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 32 *Financial Instruments: Presentation* are two of the most complex IFRS standards. They are lengthy, use technical language and often take a rule-based approach.

The impact of IAS 32 and IAS 39 is not limited to financial institutions and entities speculating on the markets. Rather, almost every business is involved in financial instruments in some way, and understanding and implementing these two standards is a challenge to chief financial officers who prepare financial statements under IFRS.

Grant Thornton International has published a guide with the aim of helping CFOs understand these standards and alerting them on when to drill down on IFRS financial instruments accounting. The guide covers:

- Which transactions give rise to financial instruments
- What is within the scope of IAS 39
- What distinguishes debt from equity
- How does IAS 39 categorize financial instruments and why does this matter
- How are financial instruments measured
- How might IAS 39 impact on seeking or renegotiating finance
- What are embedded derivatives and why are they important
- What about bad and doubtful debts
- How might IAS 39 impact on results and can this impact be mitigated
- What if my company prepares its separate financial statements under IFRS

Within each of these areas, the guide outlines the requirements in IAS 32 and IAS 39 and supplements with examples and diagrams.

Transactions and financial instruments

CFOs need to properly understand the scope of application of IAS 32 and IAS 39 before they can prepare financial statements that give a true and fair view under IFRS.

A common misunderstanding is that contingent assets or liabilities do not result in recognition of assets or liabilities by application of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

However, if the particular arrangement is contractual and an amount of cash (or other financial assets) is payable dependent on a future contingent event outside the entity's control, the contract gives rise to a financial instrument and the financial asset or liability is recognized under IAS 39, unless the financial instrument definition is flawed for some other reason or there is a specific IAS 39 scope exclusion.

Debt versus equity

The debt (financial liability) versus equity distinction is important from the issuer's perspective. In short, equity is not re-measured after recognition whereas the subsequent measurement of a debt under IAS 39 will affect

profits for the period. IAS 32 adopts the "fixed-for-fixed" test for this critical classification – a contract that fails the test is a financial liability and will often be a derivative. This means the contract will be accounted for at fair value, with changes in fair value recognized in profit or loss.

CFOs should consider the fixed-for-fixed test whenever an entity issues financial instruments, which may be settled via the issue of its own equity (such as convertible bonds). In particular, contract terms that give rise to changes in the exercise price and number of equity instrument to be issued should be handled with care. These potential changes can be purely anti-dilutive protective clauses that do not necessarily breach the fixed-for-fixed requirement.

Measurement and derecognition

IAS 39 classifies financial assets into four categories and financial liabilities into two. The measurement of the financial asset or liability is dependent on its categorization (*see table 1.1 on following page*).

The financial assets derecognition rules under IAS 39 are complex. The following five-step quick check will help CFOs assess if a transaction leads to derecognition of financial assets.

- Determine whether to apply derecognition criteria to specific assets or to a group of assets.
- Derecognize when contractual rights to assets expire or an asset has been

Financial instruments

“transferred” and the transfer qualifies for derecognition.

- Consider whether or not there has been a transfer. This is the case where either the rights to cash flows have been transferred or where the entity retains the contractual rights but assumes obligations to pay the proceeds onto a third party without delay once received.
- If a transfer has taken place, consider the extent to which risk and rewards have been retained or transferred. If substantially all risks and rewards have been transferred, the asset should be derecognized. Otherwise, the asset should continue to be recognized.
- If the entity has neither transferred nor retained substantially all risks and rewards, the entity should assess whether it retains control over the asset. If control is not retained, the asset is derecognized and the assets or liabilities retained are separately recognized.

Raising new finance and modifying existing borrowings

When raising new finances, many companies have had unpleasant surprises if they have not fully considered the IAS 32 classification of, and IAS 39 accounting for, all instruments issued.

Finance modification and restructuring is another area that imposes accounting challenges to most companies. Table 1.2 on the next page illustrates some possibilities for modifications and why careful analysis will be required case-by-case.

Embedded derivatives

Embedded derivatives are derivatives that reside within a large contract. An early repayment option in a loan agreement is a derivative embedded in a host debt contract, which is common to many businesses. IAS 39 contains detailed provisions as to when an embedded derivative exists and should be separated (*see diagram 1.3 on following page*).

IAS 39.10 notes that if a derivative is contractually transferable from a host contract, then that derivative is a stand alone and the “closely-related” test is irrelevant. The stand-alone derivative contract is always carried at fair value through profit or loss unless hedge accounting applies.

Impairment of financial assets

IAS 39 adopts the “incurred loss” impairment model to deal with bad and doubtful debts. Impairments are recognized only on the basis of one or more loss events that have occurred after initial recognition. An event is a loss event if there is a correlation between the event and a deterioration in the expected amount and/or timing of cash flows from the receivables.

IAS 39.64 requires a collective or portfolio approach to impairment assessment. In addition:

- An initial, individual review is required for items that are individually significant (IAS 39.64)

Table 1.1

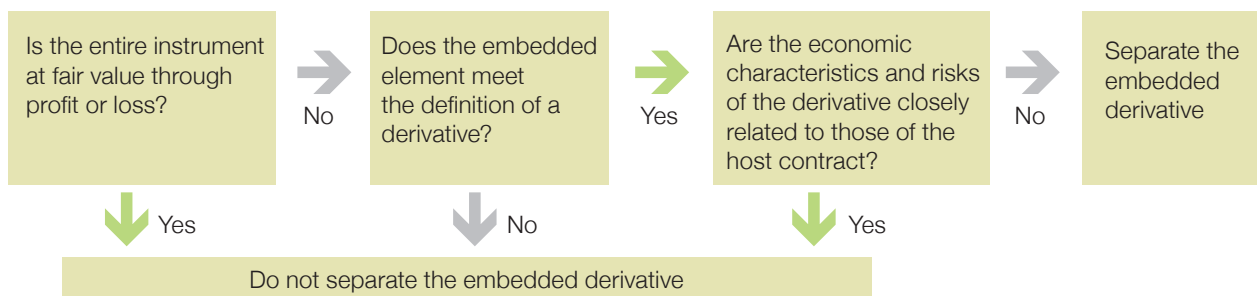
	Category	Initial measurement	Subsequent measurement	Gains and losses
Assets	Fair value through profit or loss	Fair value	Fair value	Recognized in profit or loss
	Loans and receivables	Fair value *	Amortized cost	Recognized in profit or loss
	Held to maturity	Fair value *	Amortized cost	Recognized in profit or loss
	Available for sale	Fair value *	Fair value	Fair value movements initially taken to other comprehensive income and then recycled to profit or loss on impairment or derecognition
Liabilities	Fair value through profit or loss	Fair value	Fair value	Recognized in profit or loss
	Other financial liability	Fair value *	Amortized cost	Recognized in profit or loss

* The value at inception is also adjusted for transaction costs, other than for assets or liabilities at fair value through profit or loss.

Table 1.2

Instrument before modification or restructuring	Nature of modification and resulting instrument	Accounting implications
Debt (non-convertible)	Debt but significantly modified	IAS 39.40-41 require the new instrument to be carried at fair value on inception (and the old instrument extinguished). A gain or loss is reflected in profit or loss (including the impact of transaction costs per IAS 39.AG62).
Non-convertible debt	Equity (via deal agreed to convert to equity)	Treatment depends on the overall substance. If in substance the transaction was a waiver of debt, IAS 32.35 would require recognition of a gain in profit or loss. However, as long as the conversion to equity is genuine, this is an area in which IAS 39 is not specific and so accounting policy choices are available. Possibilities may include reflecting the transaction on a no gain/no loss basis or reflecting a gain/loss based on the difference between the fair value of the shares issued in comparison to the pre-conversion carrying value of the debt (based on IAS 39.41).
Convertible debt (compound)	Convertible debt (host debt with embedded derivative)	This is where the change has involved modification such that the conversion no longer meets fixed-for-fixed. The standards are not prescriptive on this. A gain or loss arises, but there may be a choice of methods as to the underlying calculations.

Diagram 1.3



- In the collective assessment, items are grouped on the basis of common credit risk characteristics (IAS 39.AG87)
- Items are removed from the collective assessment once information becomes available that specifically identifies losses on individual items (IAS 39.AG88)
- Any individual items that are reviewed and found not to be impaired are also included in the collective assessment (IAS 39.64)

Hedge accounting to mitigate

The subsequent measurement requirements in IAS 39 often result in profit or loss volatility that would otherwise arise. Entities may wish to apply hedge accounting to mitigate these volatilities. The choice to use hedge accounting must be made at the inception of the hedge and this must be evidenced by formal documentation. Effectiveness of the hedging should be tested until hedge accounting is discontinued. The test method must be set out in the formal

documentation supporting the hedge accounting designation.

A CFO who has not previously been involved with hedge accounting needs to plan ahead. In addition to the overview of the detailed IAS 39 requirements in the guide, CFOs may refer to the comprehensive examples on cash flow hedge and fair value hedge accounting.

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