Enter a New International Accounting Era IAS 39– Financial Instruments: Classification and Measurement Principles

With the adoption of International Financial Reporting Standards (IFRS) by EU-listed companies effective 1st January 2005, IFRS has emerged as a credible International GAAP and a widely accepted alternative to US GAAP. This article provides an overview of the main theme behind the most talked about and controversial international accounting standard—IAS 39 (Financial Instruments: Recognition and Measurement).

Considering the globalisation of the Indian economy and the growing prominence of Indian businesses globally, many Indian business houses will be inclined to adopt International GAAP (Generally Accepted Accounting Principles), or the future Indian GAAP is likely to be heavily influenced by International GAAP.

IAS 39 (Financial Instruments: Recognition and Measurement) introduces a radical change in the way of classifying financial assets and financial liabilities. This classification in turn determines the basis on which the financial assets or financial liabilities are stated in the balance sheet, and the principles for accounting the effect of changes in these values in the profit or loss account.

Classification of Financial Assets and Financial Liabilities

Definitions

Before we analyse the new accounting requirements, it is essential to understand the definition of a few key terms critical to our analysis.

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These terms are (a) financial instrument (b) financial asset (c) financial liability (d) equity instrument and (e) derivative. IAS 32 (Financial Instruments: Disclosure and Presentation), has definitions of (a) to (d), while item (e) is defined in IAS 39.

a) Financial Instrument is any contract that gives rise to a financial asset of one entity and a financial liability or an equity instrument of another entity.

For example, a receivable (financial asset) of one entity will represent a payable (financial liability) of another entity. An equity instrument (or security) is a financial asset for an investor holding the instrument, and is equity of the issuer of the instrument

b) Financial asset is any asset that is:

1. Cash;
2. An equity instrument of another entity;
3. A contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity or

4. 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 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. 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.

c) Financial liability is the opposite of a financial asset.

d) Equity instrument is a contract that evidences residual interest in the assets of an entity after deducting all of its liabilities, and represents a financial asset of the holder and equity of the issuer.

e) Derivative is a financial instrument or other contract with three characteristics; viz. its value changes in response to a change in the value of an underlying factor (e.g. commodity price, interest rate), it requires nil or minimal initial investment, and it's settled at a future date.

As can be seen from the definitions above, the definition of financial asset or a financial liability centres around cash, and the contractual right to receive cash/another financial asset or a contractual obligation to pay cash/another financial right. Cash represents the basis on which all transactions are measured and recognised in financial statements, hence it is central to the definition of financial asset or financial liability.

Standard examples of financial asset or financial liability include sundry debtors/creditors, trade debtors/creditors, loans receivable/payable, investments, debentures, and bonds receivables or payable. Physical assets such as stock-in-trade, fixed assets, intangible assets and assets/liabilities that give rise to future economic benefit to receive or obligation to deliver goods or services (such as prepaid expenses, product warranty obligations, deferred revenues) are not financial assets or liabilities because these do not give rise to a present right to receive/pay cash or another financial asset.

Also, an important point to note is the need for the existence of a contractual right or contractual obligation to qualify as a financial asset or liability. Accordingly, liabilities or assets arising out of statutory requirements or constructive obligations do not fulfil the definition of a financial asset or liability.

In US GAAP (FAS 107—Disclosures about Fair Value of Financial Instruments and FAS 133—Accounting for Derivative Instruments and Hedging Activities), the definition of the term 'financial instrument' is composite and encompasses the meaning of financial asset or financial liability as well. In Indian GAAP, there is neither an equivalent standard to IAS 39/32 nor an authoritative definition of financial instrument, financial asset or financial liability.

An important point to note is the need for the existence of a contractual right or contractual obligation to qualify as a financial asset or liability. Accordingly, liabilities or assets arising out of statutory requirements or constructive obligations do not fulfil the definition of a financial asset or liability.

Classification Requirements

Let us now deal with the new types of mandated classifications and assess why these classifications are significant from the financial statements perspective. According to IAS 39, all financial instruments have to be classified into the following four categories:

Held at Fair Value through profit or loss (HaFV)	Held-to-maturity investments (HTM)
Loans and Receivables (L&R)	Available-for-sale financial assets (AFS)

A) **Held at fair value through profit or loss (HaFV):** A financial asset or financial liability falls under HaFV if:

(i) It is held for trading (HFT)

(ii) Upon initial recognition it is designated by the entity as at fair value through profit or loss.

In order to be classified as HFT, it has to be acquired or incurred for the purpose of selling or repurchasing in the near short term, or is part of a portfolio that has recent evidence of actual pattern of short-term profit-taking, or a derivative other than the one designated hedging. So, the key criterion is intention to make profit out of short-term price movements. Liabilities to fund trading assets do not necessarily from part of HFT. Interestingly, by default all non-hedging derivatives have to be classified as HFT. The rationale behind this norm for classifying the derivatives under HFT is that all HFT items have to be stated at fair value and this measure of valuation is considered to be the most appropriate method of measurement for derivatives. Recent amendments have restricted the entities' wide choice to classify any item under HaFV. The standard also places a restriction on subsequent reclassification of items initially classified as designated at fair value, possibly to prevent abuse of this classification, which gives the entity a freedom to classify any financial asset or financial liability upon initial recognition at fair value.

The definition of financial asset or a financial liability centres around cash, and the contractual right to receive cash/another financial asset or a contractual obligation to pay cash/another financial right. Cash represents the basis on which all transactions are measured and recognised in financial statements, hence it is central to the definition of financial asset or financial liability.

B) **Held-to-maturity investments (HTM):** These are defined as non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has positive intention and ability to hold to maturity. Excluded from this category are items that are classified at initial recognition at fair value through profit or loss, or available for sale, and those that meet the definition of loans and receivables (L&R). It is pertinent to note that items that meet the definition of L&R are straightaway excluded from the HTM category. Further, an entity is barred from classifying any financial asset as HTM if it has sold or reclassified a significant portion of its HTM investments before maturity during the current financial year or two preceding financial years. There are a few exceptions to this stringent rule. Possibly the underlying rationale for this stringent rule is that the standard presumes that the entity may have lost its ability or intention to hold the financial asset to maturity if a significant portion of its HTM portfolio has been sold recently. Needless to state, items that have no fixed and determinable maturity dates, such as equities, cannot be classified here.

C) **Loans and Receivables (L&R):** The definition of L&R is similar to that of HTM investments, though there are a few additional conditions/exclusions. These are: L&R should not have been quoted in an active market, the entity should not have the intention to sell these immediately or in the near future and the interest acquired in a pool of assets that are not L&R. It appears that L&R is meant only for banking and financial institutions. But it is not so because many financial assets such as trade receivables, sundry receivables, etc. in the manufacturing industry segment fall under this category. L&R is a category of financial assets resulting from supply of money (loan by a bank) as well as supply of goods/

services (sales receivables).

D) **Available-for-sale Financial Assets (AFS):** This is a residuary category for financial assets and according to the definition any financial assets that are not classified under the above three categories fall into this category. It is interesting to note that this classification cannot be used for financial liabilities.

Though not explicitly stated in the standard, there is one more classification permissible and applicable to financial liabilities, i.e., financial liabilities at amortised cost.

Measurement Principles

What does the above classification mean? Is it meant only as a disclosure requirement in financial statements? No. This classification has a significant impact on the amounts at which the various financial assets or liabilities have to be stated in financial statements. There are specific and different measurement rules for balance sheet and profit-and-loss for each of the above categories. The following table summarises these rules.

Measurement Rules for Balance Sheet and Profit-and-Loss for Various Categories

Category	Balance Sheet Valuation Basis	Treatment of Fair Value Gains or Losses
HaFV	Fair value	Profit and Loss a/c
Held-to-maturity investments	Amortised cost	Not applicable
Loans and receivables	Amortised cost	Not applicable
AFS financial assets	Fair value	Equity reserves*
Financial liabilities at amortised cost	Amortised cost	Not applicable

**to be recycled into profit-or-loss account when the financial asset is sold or disposed of*

In the measurement and valuation process, there are two clearly distinct bases used. Let us analyse what they mean in reality.

Fair Value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. The US GAAP definition differs in wording but has more or less the same meaning. IAS 39 provides substantial guidance on the practical application of the fair value concept. One has to bear in mind that fair value has to be determined based on the assumption of the 'going concern' concept, and is not based on a forced sale or distress sale situation.

It may be noted that Indian GAAP has no accounting standard similar to IAS 39, which has clear and specific requirement for classification and measurement of financial assets and financial liabilities. Though there is a standard (AS 13 Investments) in respect of a financial asset, viz. Investments, it is at significant variance with IAS 39. The differences are with respect to the basis of classification of investments and the measurement principles.

This standard states that normally the transaction price (i.e., fair value of the consideration paid/received) is the fair value at the initial recognition of a financial instrument. However, in special situations such as interest-free loans or loans at off-market interest rates, the fair value has to be determined based on an acceptable valuation technique (say, discounted cash flow method). In case of subsequent measurement of financial assets or liabilities, the fair value is the quoted price in an active market. To qualify for the meaning of fair value, the price has to be readily and regularly available from

familiar sources such as exchange houses, brokers, dealers or regulatory agencies, and for regularly occurring market transactions. The best evidence of fair value is the availability of published price in an active market for the most recent transaction. The standard recommends use of bid price for assets held or liability to be issued, and asking price for assets to be acquired or liability held.

In the absence of an active market, the standard permits the use of an appropriate valuation technique. Such techniques include discounted cash flow analysis, option pricing models, valuation techniques commonly used by market participants to price instruments, and recent arm's-length transactions. Valuation techniques have to be based on maximum use of market inputs, with very little entity-specific inputs.

Amortised cost is defined as the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method (EIR) of any difference between that initial amount and the maturity, and minus any reduction (directly through the use of an allowance account) for impairment and uncollectability. In simple terms, what it means is the amount at which the asset or liability is initially stated and adjusted for amortisation of certain eligible costs and fees incurred at the inception, discount, premium and the impairment provision. In this regard, it is important to note that the term EIR has a significant bearing on the determination of amortised cost. EIR is a method of calculating the amortised cost of financial asset or liability, and of allocating the interest income or interest expense over the relevant period. The EIR 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 financial liability. This method is similar to the 'Constant Effective Yield' method of amortising premiums/discounts in case of investment securities.

It may be noted that Indian GAAP has no accounting standard similar to IAS 39, which has clear and specific requirement for classification and measurement of financial assets and financial liabilities. Though there is a standard (AS 13 Investments) in respect of a financial asset, viz. Investments, it is at significant variance with IAS 39. The differences are with respect to the basis of classification of investments and the measurement principles. Further, the reserve Bank of India (RBI) has prescribed the IAS 39 type of classification for banks' investment portfolios, but the measurement principles do not allow full adoption of the fair value concept.

Fair Value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. The US GAAP definition differs in wording but has more or less the same meaning. IAS 39 provides substantial guidance on the practical application of the fair value concept.

We can summarise the impact of the above classifications on businesses as following:

a) All derivatives have to be recognised on balance sheets from inception

b) Wider choice for use of fair value leading to increased volatility in reported earnings

c) Need for greater understanding of fair value concepts and development of sophisticated valuation techniques for fair value measurements

d) Selection of classification to be given careful thought. HTM has attendant onerous restrictions/conditions with an effect on asset-liability management practices, whereas HaFV can lead to unwarranted/uncontrollable volatility in earnings. ❐