

IAS – 39 Financial Instruments Recognition And Measurement

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Presentation by : Farid Alam ACA

History of IAS 39

October 1984	Exposure Draft 'Accounting for Investments'
March 1986	IAS 25, 'Accounting for Investments'
Sep. 1991	Exposure Draft 'Financial Instruments'
June 1995	The disclosure and presentation portion of exposure draft adopted as IAS 32
June 1998	Exposure Draft 'Financial Instruments Recognition and Measurement'
December 1998	IAS 39 'Financial Instruments Recognition and Measurement'
October 2000	Limited Revision to IAS – 39
1 Jan. 2001	Effective Date of IAS 39 (1998)

Why IAS 39 – so important

- While going through the financial press, we find rapid financial expansion in the use of financial instruments ranging from traditional instruments like bonds to various forms of so called derivative instruments like ‘interest rate swaps’. This significant growth of financial instruments is the main reason for the development of guidance for their accounting.

Why IAS 39 – so important – contd.

- Recent high profile disasters involving derivatives (e.g. Barrings Inc.) which while not caused by accounting failures have raised eye brows on accounting and disclosure practices.

Categories Of Financial Assets

- 
- Held for Trading
 - Available for sale
 - Held – to-maturity
 - Loans and receivables originated by the enterprise

Definitions

- A financial asset or liability **held for trading** is one that was acquired or incurred principally for the purpose of generating a profit from short – term fluctuations in price or dealer's margin.
- **Held - to – maturity investments** are financial assets with fixed or determinable payments and fixed maturity that an enterprise has the positive intent and ability to hold to maturity other than loans and receivables originated by the enterprise

Definitions contd.

- Loans and receivables originated by the enterprise are financial assets that are created by the enterprise by providing money, goods, or services directly to a debtor other than those that are originated with the intent to be sold immediately or in the short term
- Available for sale financial assets are those F.A that are NOT
 - Loans and receivables originated by the enterprise
 - Held - to - maturity investments
 - Financial assets held for trading

Initial Recognition

- An enterprise should recognize a financial asset or financial liability on its balance sheet when, and only when, it **becomes a party to the contractual provisions** of the instrument. (Para 27)
- *e.g. forward contracts are recognized on the commitment date rather than waiting until the closing date on which the exchange actually takes place.*

Initial Recognition cont.

- Which means - All financial assets and financial liabilities should be recognized on the balance sheet, including the derivatives.
- One can infer from the above that IAS 39 requires “Trade Date Accounting” but that is not the case. In a contract for purchase or sale of Financial Assets requiring delivery of the assets within a time frame generally established by the regulation or convention in the market place concerned – called a “regular way” contract is also allowed as explained :-

Trade Date Vs. Settlement Date

- A “regular way” purchase or sale of financial assets should be recognized using either:
- ‘Trade date accounting’ or ‘Settlement date accounting’
- The method used should be applied consistently for all purchases and sales of F.As that belongs to the same category

At KSE regular way is to settle a transaction is $T + 3$

Illustration to show Settlement/Trade Date Accounting

29/12 Commits to purchase F.A. 1000
(including transaction costs)

31/12 Fair Value 1002

Financial Year end

04/01 Fair Value 1003

(settlement date)

Settlement Date Accounting

Date	Held to Maturity Carried at amortized cost	Available for Sale- remeasured to fair value with changes in equity or P&L	Held for Trading Re measured to Fair value with changes in P&L
29/12	-	-	-
31/12	-	Receivable 2 Equity 2 Or P/L a/c 2	Receivable 2 P/L a/c 2
04/01	F.A. 1000 Cash 1000	F.A. 1003 Receivable 2 Equity 1 Cash 1000 Or Receivable 2 P/L a/c 1 Cash 1000	F.A. 1003 P/L a/c 1 Receivable 2 Cash 1000

Trade Date Accounting

Date	Held to Maturity Carried at amortized cost	Available for Sale- remeasured to fair value with changes in equity or P&L	Held for Trading Re measured to Fair value with changes in P&L
29/12	F.A. 1000 Payable 1000	F.A. 1000 Payable 1000	F.A. 1000 Payable 1000
31/12	-	F.A. 2 Equity 2 Or P/L a/c 2	F.A. 2 P/L a/c 2
04/01	Payable 1000 Cash 1000	1)F.A. 1 Equity 1 Or P&L 1 2)Payable 1000 Cash 1000	F.A. 1 P/L a/c 1 Payable 1000 Cash 1000

De recognition

- An enterprise should de recognize a financial asset when it is no longer has **control** over the financial assets.

Treatment of Profit or Loss on De recognition of F.A – Case 1

Proceeds received or receivable	xx
Any prior adjustment to reflect F.V of that asset that had been reported in equity	xx/(xx)
Less: carrying amount of an asset transferred	<u>xx</u>
The amount to be included in P& L	<u>xxx</u>

Treatment of Profit or Loss on De recognition of F.A – Case 2

Proceeds recd or recble for the portion sold	1,050
Any prior adjustment to reflect F.V of the portion sold that had been reported in equity	0
Less: carrying amount (C.A) of the portion of the asset sold	(910)
The amount to be included in P& L	140

C.A = The carrying amount of the F. A should be allocated between the part retained and the part sold based on their relative fair values on the date of sale.

Example

- An enterprise originates Rs. 1000 of loans that yield 10 % interest for their estimated lives of 9 years. The enterprise sells the Rs.1000 principal + the right to receive interest income of 8 % to another enterprise for Rs. 1050. The transferor will continue to service the loan and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest portion not sold is considered an interest – only strip receivable. At the date of transfer the Fair value of the loans, including servicing, is Rs. 1,100 of which the fair value of the servicing asset is Rs.40 and the fair value of the interest-only strip is Rs.60. Required Allocate the amount of Rs.1,000 (carrying amount of the loan)

Example cont.

	F.V	% of total F.V	Allocated C.A
Loans sold	1,000	91	910
Servicing Asset	40	3.6	36
Interest only strip receivable	60	5.4	54
Total	1,100	100	1,000

Case 2 – cont.

- In the rare circumstance that the fair value of the part of asset that is retained can not be measured reliably, then that asset should be recorded at zero. The entire carrying amount of the F.A should be attributed to the portion sold.

Example

Same information as in previous example except: at the date of transfer the F. V of the servicing asset and interest only strip receivable can not be measured reliably

Required: Allocate the Rs. 1,000 carrying amount of the loan

	F.V	% of total F.V	Allocated Carry Amt
			1,000
Loans sold	1,000	91	
Servicing Asset	Not det	Not det	0
Interest only strip receivable	Not det	Not det	0
Total	1,100		1,000

Example cont.

Proceeds recd or recble for the portion sold	1,050
Any prior adjustment to reflect F.V of the portion sold that had been reported in equity	0
Less: carrying amount (C.A) of the portion of the asset sold	(1,000)
The amount to be included in P& L	50

Case - 3

- De recognition coupled with a new financial Asset or Liability

If an enterprise transfers control of entire financial asset but, in doing so, creates a new financial asset or assumes a new financial liability, the enterprise should recognize the new F.A or F. L at fair value

e.g., Selling a portfolio of receivables while assuming an obligation to compensate the purchaser of the receivable if collections are below a specified level

De recognition of Financial Liability

- IAS 39 provides that a financial liability should be removed from the balance sheet when the contractual obligations are extinguished (discharged , cancelled or expired) or when the primary obligation is transferred to another party
- As with a financial asset, an enterprise may also transfer a portion of the financial liability or assumes a new financial asset or liability as a result of the transfer. In such cases the rules for allocation and recognition of the gain or loss are the same as for F.Assets

Measurement

Initial Measurement

Financial instruments
Are initially measured
At cost – This is the
fair value of the consid-
-eration given or
received

Subsequent Measurement

All financial assets should be
measured to fair value except
for the following:

1. Loans and receivables
originated by the enterprise
2. Other fixed maturity
investments
3. Financial assets whose F.V can
not be reliably measured

Gains and Losses on F.A & F.L not re measured to fair value (para 108)

- A gain or loss is recognized in net profit or loss when the financial asset or liability is de recognized or **impaired**, as well as through the amortization process

Gains and Losses on Re measurement to F.V (para 103)

An enterprise will have a single, enterprise – wide option to either:

1. Recognize the entire adjustment in net profit or loss for the period, or
2. Recognize in net profit or loss for the period only those changes in F.V relating to F. A & F.L held for trading, with the value changes for non trading instruments reported in [equity](#).

BSD Circular 20 dated August 04, 2000 issued by SBP

The circular requires, inter alia, all banks and NBFIs to revalue their security (Investments) holdings on a weekly basis according to the basis of PKR (Reuters page) for government securities and

In case of quoted securities closing rate of KSE.

Moreover, any surplus/deficit arising on revaluation of securities will **not be taken to P/L a/c** except when actually realized and instead will be kept in a separate a/c called “Surplus/Deficit in Revaluation of Securities” which will be shown **below equity** and its breakup may be given in the notes to the financial statements without distinction between long term and short term investments.

BSD 20

Please note its contravention with:

- a) Clause 1(G) viii of part III of fourth Schedule to Companies Ordinance 1984 clearly requires inclusion and disclosure of provision for diminution in value of investments in profit and loss account. (Loss only)
- b) IAS 39 (revised 2000) requires gain and losses on re-measurement to fair value of a financial asset and financial liability held for trading should be included in net profit or loss for the period. Those which are not held for trading, an enterprise will have a single enterprise wide option to either recognize the entire adjustment in the P&L A/C or report in equity until the financial asset is sold.

BSD 20

- In order to bring the annual financial statements of the financial institutions in line with the Companies Ordinance 1984 and IASs , we propose that the Director Technical Services, ICAP should take up this matter with SBP and request for a specific waiver of the provisions of this circular on the annual financial statements although for reporting to SBP the treatment may continue.

Impairment & Un collectability of F.A (Para 110)

Evidences of Impairment

- Significant financial difficulty of the issuer;
- An actual breach of contract, such as a default or delinquency in interest or principal payments;
- Granting by the lender to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, of a concession that the lender would not otherwise consider;
- A high probability of bankruptcy or other financial reorganization of the issuer;
- Recognition of an impairment loss on that asset in a prior financial reporting period;
- The disappearance of an active market for that financial asset due to financial difficulties; or
- A historical pattern of collections of accounts receivable that indicates that the entire face amount of a portfolio of accounts receivable will not be collected.

Impairment Of Assets = CA > Est.RA
(Paras 109,111,115)

F.A. carried at
amortized cost

PV of
expected
future cash
inflows
discounted at
**original
effective**
interest rate
(Para 111)

F.A. carried at
amortized cost
because FV can
not be reliably
measured

PV of expected
future cash flows
discounted at
current market
rate of interest for
a similar FA

F.A. remeasured to fair
value (Para 117)

If loss recognized in
equity .. Evidence of asset
impairment.. The
cumulative net loss
recognized earlier in
equity should be removed
from equity and
recognized in net P/L for
the period though FA not
derecognized

Financial Asset remeasured to F.V.

Para 118

Amount of loss (that had been recognized directly in equity)
to be recognized in net profit or loss for the period

Financial Assets
(Equity Instruments)



Acquisition cost less current
F.V. less any impairment
loss previously recognized

Financial Assets
(Debt Instruments)



Acquisition Cost less recoverable
amount less any impairment loss
previously recognized

Recoverable amount = PV of expected future cash flows
discounted at the current market rate of interest for a similar F.A.

Reversal in impairment

- Impairment or bad debt loss decreases after the write down should be reversed either directly or by adjusting an allowance account.
- The reversal should **not** result in a CA of the FA that exceeds what amortized cost would have been, had the impairment not been recognized (at the reversal date).
- The amount of reversal should be included in net profit or loss for the period.

Hedge Accounting

- For accounting purposes, hedging means designating one or more hedging instruments so that their change in fair value is an off set , in whole or in part, to the change in fair value or cash flows of a hedged item.

Criteria for hedge accounting

All of the following criteria **MUST** be met

- Hedging relationship must be designated at its inception as a hedge based on the enterprise risk management objective & strategy with formal documentation
- The hedge should be **highly effective**
- For cash flow hedges, a forecast transaction that is the subject of the hedge must be **highly probable**
- The effectiveness of the hedge can be **measured reliably**
- The hedge has been **effective during the reporting period**

Hedged Item

- A hedged item is an asset, liability, firm commitment, or forecasted future transaction that:
 - A) **exposes** the enterprise to risk of changes in fair value or changes in future cash flows and that;
 - B) For hedged accounting purposes, is **designated** as being hedged.

Hedging Instrument

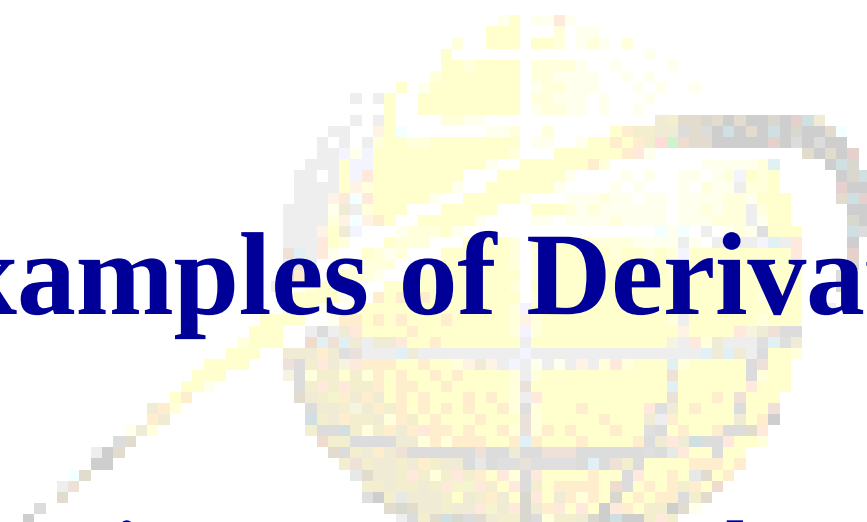
- For hedge accounting purposes, is a designated **derivative**
- In limited circumstances, a **non-derivative** financial asset or liability; **only if** it hedges the risk of changes in foreign currency exchange rates

Derivative defined

- A derivative is a financial instrument:
 - (a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange, index of prices or rates, a credit rating or credit index or similar variable (some times called the ‘underlying’);
 - (b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
 - (c) that is settled at a future date.

Hedge Effectiveness

- Is the degree to which offsetting changes in fair value or cash flows attributable to a hedged risk are achieved by the hedging instrument.
 - How To Assess ?
- Regarded as highly effective if at inception and throughout the life of the hedge, the enterprise can expect changes to almost fully offset; in simple words actual results are within a range of 80 % - 125 %



Examples of Derivatives

Options, Futures and Swaps



Definition

An **Option** is a right, but not an obligation, to buy or sell, a specified amount of an underlying asset, at an agreed upon price, on or before a specified date

Benefits

Ability to take positions at other than current market levels

- Options available in-the-money, at-the-money and out-of-the-money
- Futures and forward contracts available only at current market (i.e. at-the-money)

Benefits

Leverage

- Full participation in gains with small initial outlay
 - No margin required for buyers
 - Margin is required for writers
- Futures contracts subject to margin requirement

Basic Components

Types of Options

- **Call-** Right to BUY a specified amount of underlying asset
 - **Put-** Right to SELL a specified amount of the underlying asset
- 

Underlying Asset

This is the asset which the Option Buyer has the right to buy or sell- Bonds, Foreign Exchange, Futures Contracts

Basic Components

Strike Price or Exercise Price

This is the price at which the underlying asset can be bought or sold

Premium

This is the cost of the Option- the amount (fee) paid by the Option buyer to the Option seller

Basic Components

Time to Expiration or Maturity

This is the amount of time remaining that the Option buyer has the right to exercise the option.

There are two types of options:

- **European Option**- The Option buyer has the right to exercise only on the maturity date
- **American Option**- The Option buyer has the right to exercise at any time on or before the maturity date

Basic Components

Categories of traders

- Option Buyers
- Option Sellers



Option Buying and Option Writing

An option contract gives the buyer of the option the right to require the writer of the option to perform according to the stated provisions of the contract

- **Buyer**- Pays a fee, or premium, to obtain this right, and has a long position in the option
- **Writer (Seller)**- Receives the premium in return for granting the option, and has a short position in the option

Foreign Exchange Options

Option to buy one currency and sell another at a fixed exchange rate (strike price)

Example

- Customer buys FX option from Citibank
- Option to buy SF 1 MM at SF 2.30 = USD 1 within net 6 months
- If rates > 2.30 , customer will not exercise
- If rates < 2.30 , customer will exercise



Futures

Currency futures are forward transactions with standard contract sizes and maturity dates which are traded on a formal exchange.

The contract is a binding obligation to buy or sell one currency against another at an agreed rate of exchange for a future delivery date.

Types of Futures

- Currency futures against the USD
- Currency futures involving cross rates - two non-USD currencies.



Hedging with Futures

- Commonly used by traders in banks to **Hedge** future currency risk.
- To Hedge, players take **opposite** positions to expected future positions.

Hedging with Futures - Going Long

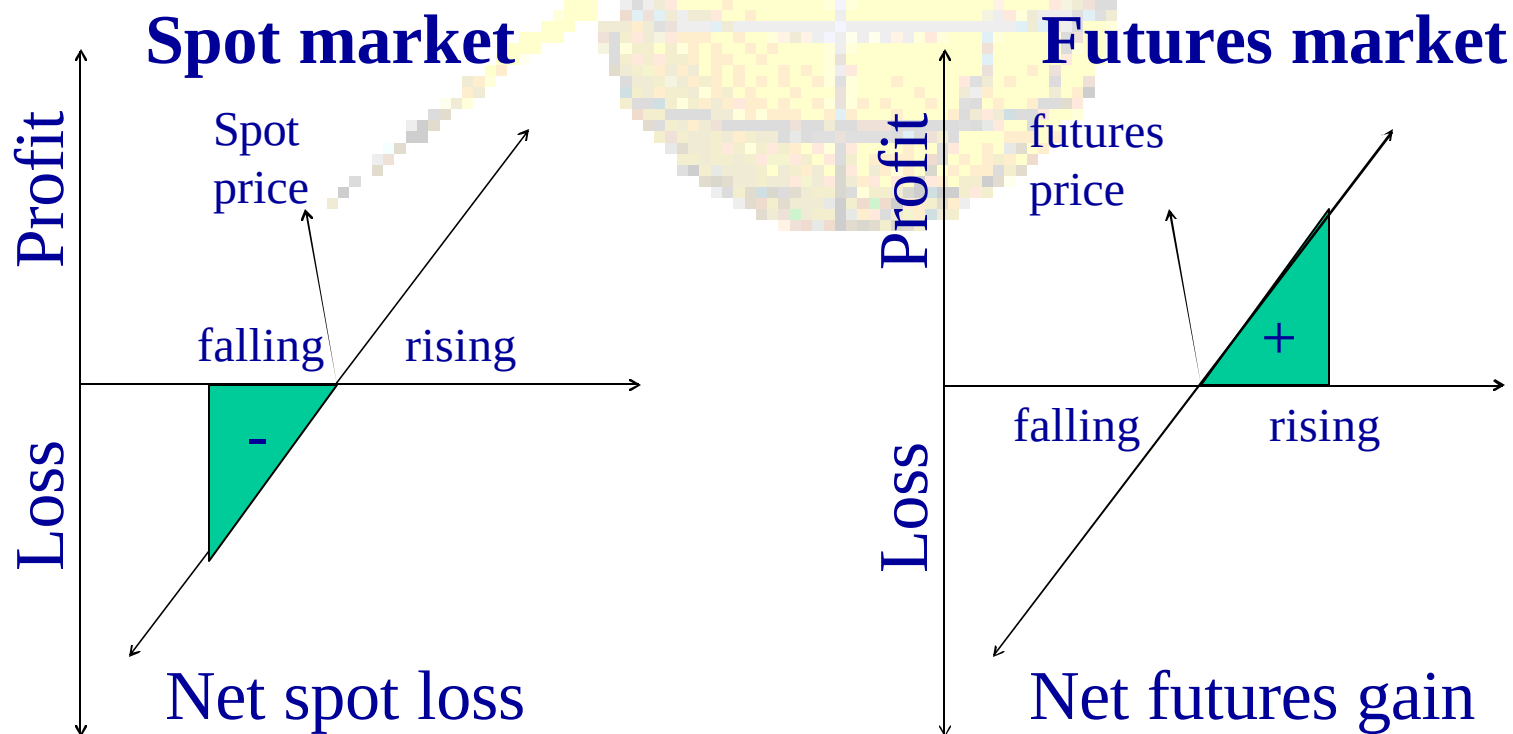
- **Long hedge** : Buy futures contract
- **Objective** : Protection against a rise in foreign currency value
- **Typical use** : An importer would need protection against rise in value of the foreign currency, until the agreed delivery date.

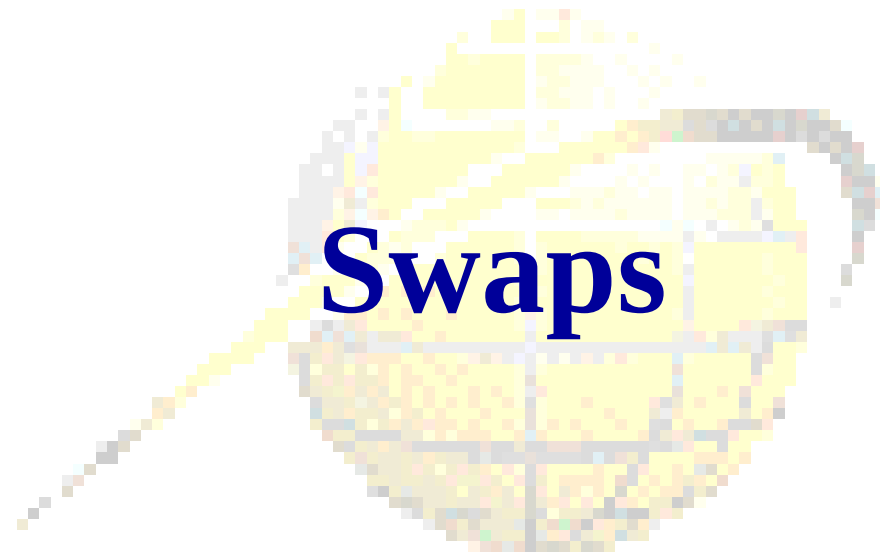
Hedging with Futures - Going Short

- **Short hedge** : Sell futures contract
- **Objective** : Protection against a fall in foreign currency value
- **Typical use** : An importer would need protection against fall in value of the foreign currency, until the agreed delivery date

Example

- US import of DEM 125,000.
- Settlement in 3 months.
- Spot rate USD/DEM : 1.6600





Swaps

The purchase/sale of a currency for one value date coupled with its resale/repurchase at a later value date, usually at different exchange rates for the two transactions (the difference represents the premium or the discount).

Swap transactions usually involve a spot plus a reversing forward transaction. Both value dates may also involve two future dates, that is, purchase the currency for value 1 month and sell the same currency for value 3 months.

Types of Swap Transactions

- **Pure Swap** - Purchase and sale of the same currency for different value dates with the *same counter-party*.
- **Engineered Swap** - Purchase and sale of the same currency the different value dates but with different *counter-parties*.

Example

- If the loss on the hedging instrument is 120 & the gain on the cash instrument is 100, offset can be measured by $120/100$, which is 120 %, or $100/120$, which is 83 %.

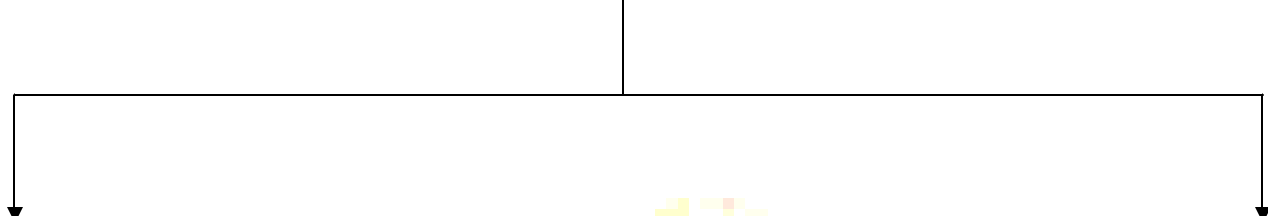
Conclusion

The hedge is highly effective.

From financial management perspective

$$\begin{aligned}\text{Hedge Effectiveness} &= \frac{\text{Opportunity gained}}{\text{Opportunity lost}} \\ &= \frac{100}{120} = 83 \%\end{aligned}$$

Types of Hedge



Fair Value Hedge

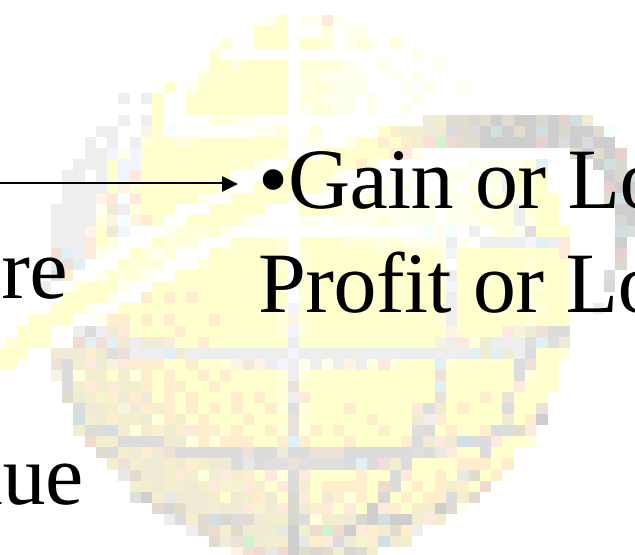
A hedge of the exposure to changes in the fair value of a recognized asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and that will effect reported **NET INCOME**
e.g. Put or Call option of publicly traded shares

Cash Flow Hedge

A hedge of the exposure to variability in cash flows that

- Is attributable to a particular risk associated with a recognized asset or liability(such as all or some of future payments on variable payment debt) or a forecasted transaction (such as an anticipated purchase or sale) and that
- Will effect reported **NET P/L**
- e.g., an interest rate swap, cap or collar

Accounting for Fair Value Hedges

- 
- Hedging instrument re measured at Fair Value → • Gain or Loss to Net Profit or Loss
 - Hedged Item → • Carrying amount adjusted
• Gain or Loss to Net Profit or Loss

EXAMPLE

This example is presented from the perspective of the holder

- In year 1, an investor purchases for 100 a debt security that is classified as available for sale. At the end of year 1, current fair value is 110. Therefore, the 10 increase is reported in equity (assuming the investor has elected this method), and the carrying amount is increased to 110 in the Balance sheet. To protect the 110 value, **the holder enters into a hedge by acquiring a derivative**. By the end of year 2, the Derivative has a gain of 5, and the debt has a corresponding decline in fair value

Example Cont.

Investors Books Year 1

- Debt Security

Dr.

100

Cr.

Cash

100

- Debt Security

10

Equity

10

Investors Books Year 2

- Derivative Asset

5

P&L A/C

5

- Profit & Loss

5

Debt Security

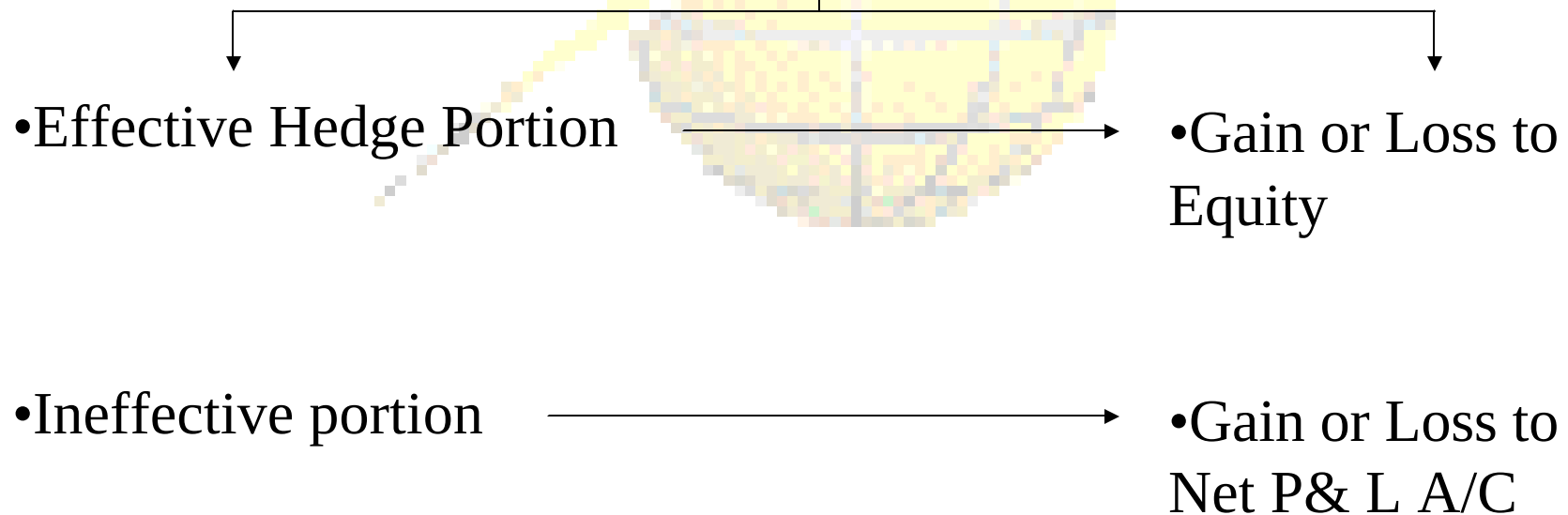
5

The carrying amount of the debt security is 105 at the end of year 2, & that of derivative is 5.

The gain of 10 reported in equity will remain there until the debt security is sold.

Accounting for Cash Flow Hedge

- Re Measurement of Hedging Instruments



Illustration

Loan obtained	100
Interest	10% p.a. (Variable)
Hedging Instrument	Effective hedge (80%)
Actual Interest Payment	15
Loss	5 (15-10)
Hedge Effectiveness	$5 \times 80\% = 4$
Gain on Hedging Instrument	11

Hedging Instrument 11

Equity (Effective) 4

P/L a/c 7

Discontinuance of Hedge Accounting

- Hedging Instrument
 - Expires
 - Sold
 - Terminated
 - Exercised
- Hedge no longer meets criteria

Investments in foreign entity

- Hedge of net investment in foreign entity should be accounted for in accordance with IAS -21 The effects of changes in foreign exchange rates

Disclosures

- All of the disclosure requirements of IAS 32 are applicable except that the supplementary disclosure for fair values is no longer necessary for those financial instruments that are measured at fair value.
- Additional disclosures
 - a) The enterprise accounting policies should describe its financial risk management objectives and policies, including its policy for hedging each major type of forecast transaction
 - b) Separate disclosures are required for:
 - Fair value hedges
 - Cash flow hedges
 - Hedges of a net investment in a foreign entity
 - Gains and losses on derivative and non derivative assets and liabilities designated as hedging instruments in cash flow hedges that have been recognized in equity

Disclosures cont.

collateral

- A borrower should disclose the carrying amount of financial assets pledged as collateral for liabilities and any significant terms and conditions relating to pledged assets; and
- A lender should disclose:
 - The Fair value of collateral (both financial and non – financial assets) that it has accepted and that it is permitted to sell or re pledge in the absence of default;
 - The Fair value of collateral that it has sold or re pledged; and
 - Any significant terms and conditions associated with its use of collateral
- Various other additional disclosures relating to financial instruments.

