

Practical Workshop for NBU Staff

IAS 39: Financial Instruments - Recognition and Measurement



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IAS 39 Overview

- » Recognition and measurement of financial assets and financial liabilities as defined by IAS32
- » INITIAL RECOGNITION when entity becomes party to contractual provisions of instrument.
- » Classification of instruments into different categories, leading to different SUBSEQUENT MEASUREMENTS, typically amortized cost or fair value. Special rules for embedded derivatives and hedging instruments.



Interpretations/scope exclusions

» Related Interpretations:

- » IFRIC 16: Hedge of a net investment in a foreign operation
- » IFRIC 12: Service concession Arrangements
- » IFRIC 9: Reassessment of embedded derivatives
- » Scope exclusions: Same as for IAS 32



IAS 39: Precisions on scope

- » LEASES : IAS 39 applicable to lease receivables and payables for derecognition and impairment, and to embedded derivatives.
- » FINANCIAL GUARANTEES: IAS 39 applies, unless option for IFRS 4 (Insurance contracts) in limited circumstances
- » LOAN COMMITMENTS: normally scoped out if cannot be settled net in cash, if no election for FVTPL, no past practice of immediate selling. Commitment to provide a loan below market rate recognised initially at fair value (FV), subsequently under IAS 37

IAS 39 :Precisions on scope (continued)

- » **CONTRACTS TO BUY OR SELL NON-FINANCIAL ITEMS:** scoped in if they can be settled net in cash or another financial asset and are not held to satisfy entity's purchase, sale and usage requirements.
- » **Situations of net settlement:**
 - » (1) contract permits either party to settle net;
 - » (2) past practice of net settling;
 - » (3) non financial item readily convertible to cash.
- » **WEATHER DERIVATIVES :** scoped in if not included in IFRS 4 (Insurance contracts)



Examples of Financial Instruments

- » Cash; demand & time deposits; commercial paper; accounts notes and loans receivable and payable.
- » Debt and equity securities (both for holder and issuer)
- » Asset backed securities: collateral mortgage obligations, securitized packages of receivables.
- » Derivatives: Financial instruments whose value change in response to the change in an underlying variable, such as an interest rate, commodity or security price or index.



Examples of derivatives

- » Forwards; futures; Interest rate swaps and forward rate agreements
- » Options: contracts that give the purchaser the right , but not the obligation, to buy (call option) or to sell (put option)a specified quantity of a particular FI, commodity or foreign currency at a specified price, during a specified period of time. The purchaser of the option pays the seller (writer) a premium.



Embedded derivatives

- » Some contracts that are not FI may have FI embedded in them
- » EX: a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative indexed to the price of the commodity
- » An embedded derivative, although within a contract, behaves like a stand-alone derivative. If embedded derivative is NOT CLOSELY RELATED to its host contract, it must be separated and accounted for as a derivative. The host contract is accounted under the appropriate standard (Appendix A of IAS 39)



The four categories

- » Financial assets classified in:
 - » Financial assets at fair value through profit and loss (FVTPL)
 - » Available for sale Financial assets (AFS)
 - » Loans and receivables
 - » Held- to-maturity Investments (HTM)



Embedded Derivatives (continued)

- » Examples of embedded derivatives not closely related to host.
- » Equity conversion option in debt convertible to ordinary shares (for holder); Commodity indexed interest and principal payments in host debt contracts.....
- » If IAS 39 requires separation , but entity unable to measure the derivative separately, the whole contract measured at FVTPL.



Financial assets at FVTPL

- » Two sub-categories: Designated at initial recognition and Held for trading.
- » Held for trading includes all derivatives (except if designated as hedging instruments), and financial assets held for the purpose of selling in the short term or for which there is a pattern of short term profit taking.



Available for sale Financial Assets (AFS)

- » AFS: Non-derivative FI designated on initial recognition or any other instrument not classified as “loans and receivables” or “held to maturity” or FVTPL.
- » Measured at fair value, with gains and losses in OCI. On derecognition or if impaired, recycling to P&L.
- » Impairment is triggered for an equity investment in case of significant or prolonged decline in the fair value.



Loans and Receivables

- » Non-derivative Financial Assets with fixed or determinable payments, not quoted on an active market. (Other than held for trading or designated at FVTPL or AFS.)
- » Measured at amortized cost, using the effective interest method.



Held-to-Maturity Investments (HTM)

- » Non-derivative Financial assets with fixed or determinable payments an entity intends and is able to hold to maturity.
- » Debt instruments (bonds) are in that category, as they have a maturity date. (Contrary to shares).
- » “Tainting”: if an entity sells HTM instruments before maturity for a significant amount and the sale is not due to an isolated event beyond its control, all HTM investments are reclassified as AFS for the current year and the next two.
- » HTM investments are measured at amortized cost using the effective interest method.



Classification of financial liabilities

» 2 classes:

- » FVTPL: applies to liabilities designated on initial recognition and to liabilities held for trading (such as an obligation for securities borrowed in a short sale, to be returned later).
- » All other financial liabilities, measured at amortized cost using the effective interest method.



Initial recognition and measurement

- » Recognition when the entity becomes a party to the contract. Accounting policy choice, by category, between trade date and settlement date.
- » Initially, FA and FL are measured at fair value (including transaction costs for assets and liabilities not measured at FVTPL)



Subsequent measurement

- » Loans and receivables, HTM and non derivative financial liabilities: at amortized cost
- » Equity instruments with no reliable fair value measurement: at cost
- » Instruments designated in a hedge relationship follow special rules
- » All other instruments: at fair value.



Fair value option

- » On initial recognition, an accounting policy choice permits to designate an instrument at FVTPL if this eliminates or reduces an accounting mismatch, or if a group of financial instruments is managed and measured on a fair value basis and reported as such to key management. Cannot be reclassified out of this category with some exceptions.



Amortized cost

» Amortized cost is calculated using the effective interest method. Effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the instrument to its net carrying amount



Impairment of financial assets

- » Impairment recognised only on objective evidence of events occurred after initial recognition.
- » Assets for which no individual impairment exists are grouped with similar assets and the group is tested for impairment.
- » Impairment may be reversed through P&L, except for AFS equity instruments.

Summary of subsequent measurement - Financial assets

Category – WHAT	Subsequent measurement – HOW MUCH	Gains and losses –WHERE
Financial assets at fair value through profit or loss	Fair value	Profit or loss
Held-to-maturity financial investments	Amortized cost using the effective interest method	Profit or loss
Loans and receivables		Profit or loss
Available-for-sale financial investments except below	Fair value	Other comprehensive income (except for impairment and foreign exchange gain/loss)
Investments in equity instruments with no reliable fair value measurement and derivatives linked to them	Cost	Impairment to profit or loss
Financial assets designated as hedged items	See Hedge Accounting	See Hedge Accounting
Derivative financial assets	Fair value	Profit or loss

Summary of subsequent measurement – Financial Liabilities

Category – WHAT	Subsequent measurement – HOW MUCH	Gains and losses –WHERE
Financial liabilities at fair value through profit or loss	Fair value	Profit or loss
Other financial liabilities	Amortized cost using the effective interest method	Profit or loss
Financial liabilities designated as hedged items	See Hedge Accounting	See Hedge Accounting
Derivative financial liabilities	Fair value	Profit or loss
Financial liabilities arising when transfer of financial asset does not qualify for derecognition or is accounted using continuing-involvement method	Measured in line with specific IAS 39 provisions related to transfers / continuing involvement	Profit or loss



Derecognition of a financial asset

- » Derecognition may concern an asset in its entirety, specifically identified cashflows or fully proportionate shares of cash flows.
- » Then, see whether the asset has been transferred, and if so, whether the transfer is eligible for derecognition.
- » The exercise involves an assessment of risks and rewards, control and continuing involvement
- » See decision tree in AG36.



Hedge accounting

- » Hedge accounting is an optional treatment. An entity may hedge without using the special provisions of hedge accounting.
- » A hedging relationship exists upon designation and documentation of a relation between a hedged instrument and a hedging instrument
- » A hedged item is an instrument that exposes the entity to risks of changes in FV or future cash flows and is designated as being hedged.
- » A hedging instrument's FV or cash flows are expected to offset the changes in the hedged item.



Hedge accounting (continued)

- » All derivatives with an external counterparty may be hedging instruments
- » Hedged instruments may be:
 - » recognized assets, liabilities, or firm commitments or highly probable transactions, or a net investment in a foreign operation;
 - » a HTM investment for foreign currency or credit risk;
 - » a portion of the cash flows or fair value of a financial instrument;
 - » a non-financial item for foreign currency risk



Hedge accounting (continued)

- » EFFECTIVENESS must be assessed prospectively and retrospectively.
- » Effectiveness must be within a range of 80% to 125%
- » All ineffectiveness to be recognized immediately in P&L
- » CATEGORIES OF HEDGES: fair value hedge, cash flow hedge, hedge of net investment in a foreign operation.
- » A hedge of foreign currency risk in a firm commitment may be treated as a FV hedge or as a CF hedge.
- » Hedge accounting is discontinued if hedging instrument is sold or expires, if criteria no longer met, if forecast transaction no longer expected to occur, if revoked.



Hedge Mechanisms

- » **FAIR VALUE HEDGE:** Gain or loss on the FV of hedging instrument recognised in P&L; amount of hedged item adjusted with same amount and also recognised in P&L
- » **CASH FLOW HEDGE:** Gain or loss on hedging instrument recognized in OCI or equity and recycled into P&L in the same period as the gain or loss on the hedged instrument.
- » Special provisions apply to so-called macro-hedges.



IAS 39: Quiz

» What is IAS 39:

1. Financial Instruments: Recognition & Measurement
2. Preparation of Financial Statements
3. Depreciation Accounting
4. Cash flow Statement