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IAS® Standard 32 Financial Instruments: Presentation

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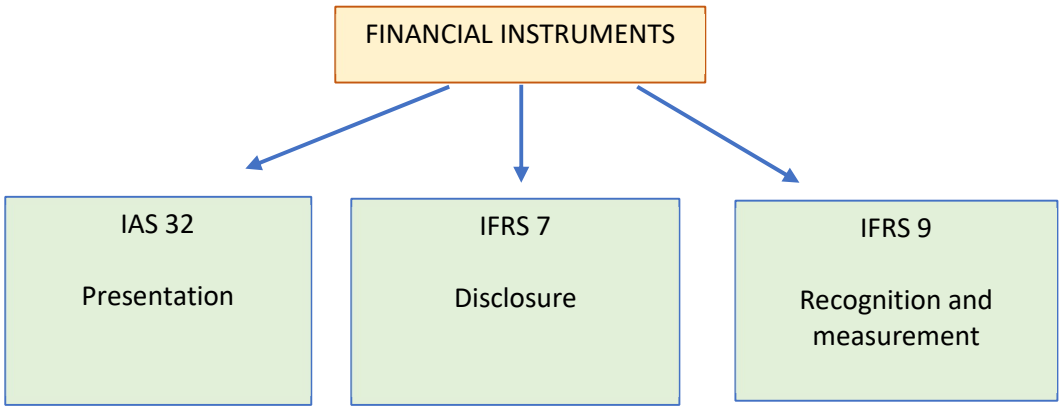
IAS® Standard 32 Financial Instruments: Presentation

OBJECTIVE AND SCOPE

Accounting and valuation of financial instruments is a comprehensive and complex issue. For this reason, some elements of accounting and reporting of financial instruments are handled in separate standards as shown in Figure 1.

Figure 1: Accounting for Financial Instruments



IAS Standard 32 Financial Instruments: Presentation is not concerned with the recognition, measurement and disclosure of financial instruments. The purpose of IAS 32 is to determine the principles regarding the classification of financial instruments as assets, liabilities and equity elements, and the circumstances in which financial assets and financial liabilities will be offset.

Classification of financial instruments as financial liabilities and equity instruments will have two important implications for financial reporting. First, items classified as financial liabilities will fall within the scope of IFRS Standard 9 Financial Instruments. Thus, they will be subject to the recognition and measurement rules of IFRS 9. Secondly, non-principal payments for instruments classified as financial liabilities will be classified as interest and reported at profit or loss. However, payments made for equity instruments will not be associated with profit or loss, they will be directly reduced from the equity.

This standard applies to all financial instruments with the few exceptions presented below.

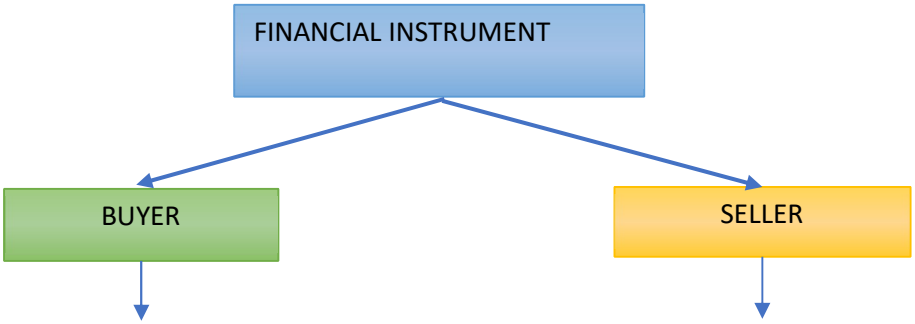
- Financial investments over which the entity has control, joint control, and significant influence. However, if these investments are to be reported in accordance with IFRS 9, this standard will be valid for the relevant financial instruments.
- Employers' rights and obligations under employee benefit plans
- Contracts within the scope of IFRS Standard 17 Insurance Contracts
- share-based financial instruments, contracts, and obligations payment transactions

KEY DEFINITIONS

While a financial instrument represents a financial asset for one business, it represents a financial liability or equity element for another business. Since the main purpose of this standard is to classify financial instruments, it is necessary to understand the definition of financial instrument as well as the concepts of financial asset, financial liability and equity instrument.

A *financial instrument* is any contract that gives rise to a financial asset of one entity and to a financial liability or equity instrument of another entity (IAS 32.11). A financial transaction will have two parties as presented in Figure 2. One of these parties is in the position of the buyer (investor) while the other is in the position of the seller (issuer). While determining the buyer and seller, the party that will increase the assets of the relevant contract should be determined first.

Figure 2: Classification of Financial Instruments



In a situation where two businesses are trading, let's assume that one of the parties sells the goods and agrees to receive the price of the goods later. In this case, a contract is formed between the seller and the buyer. After the seller delivers the goods to the buyer, she will have the right to collect the price of these goods from the buyer in the future. The buyer has an obligation to provide cash or other financial assets due to this contract. With this transaction, a financial instrument will be formed between two businesses, which enables one entity to receive cash from the other entity. In this case, the rights (assets) of the seller and the obligations (liabilities) of the buyer will increase.

A *financial asset* is any asset that is:

a. cash;
b. an equity instrument of another entity;
c. a contractual right to receive cash or another financial asset from another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
d. a contract that will or may be settled in the entity's own equity instruments

A *financial liability* is any liability that is:

a. a contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
b. a contract that will or may be settled in the entity's own equity instruments

Equity instrument, on the other hand, is defined by associating with the liabilities of the issuer. An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

PRESENTATION OF FINANCIAL INSTRUMENTS

The basic rule in IAS 32 is to classify financial instruments as financial assets, financial liabilities, or equity instruments at the time of recognition. There are two guiding principles in this moment of recognition. These are the definitions of financial instruments and the substance over form principle.

It is relatively easy to distinguish a financial asset from a financial liability or equity instrument. However, distinguishing a financial liability from an equity instrument can sometimes be challenging. For example, suppose that a toy manufacturer sells toys worth CU 10,000 to a toy shop on credit. In this case, the toy manufacturer obtained a contractual right to receive cash from the toy shop. On the other hand, the toy shop has a contractual obligation to deliver cash to the toy manufacturer. Thus, the toy manufacturer will report a financial asset after this sale, while the toy shop will report a financial liability.

Now let's change the conditions of the above operation. Assume that the toy manufacturer again sells toys worth CU 10,000 to the toy store on credit. Let's assume that there are three different alternatives to the toy store's payment:

a. The toy shop will pay with the shares of another business valuing CU 10,000.
b. The toy shop will pay with its own share totalling CU 10,000.
c. The toy shop will pay with its 50 own shares.

In all three cases, the toy manufacturer will report a financial asset, however it should be evaluated whether the toy store will report a financial liability or equity instrument.

To answer this example, we need to understand the principle established for classifying a financial instrument as a financial liability or equity instrument. The general framework for this classification is summarized in Figure 3. Our starting point for classification is to determine whether the relevant financial instrument is an equity instrument. If the financial instrument does not meet the conditions of being an equity instrument, it should be classified as financial liability. Being an equity instrument requires meeting both of the following terms (IAS 32. 16):

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

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

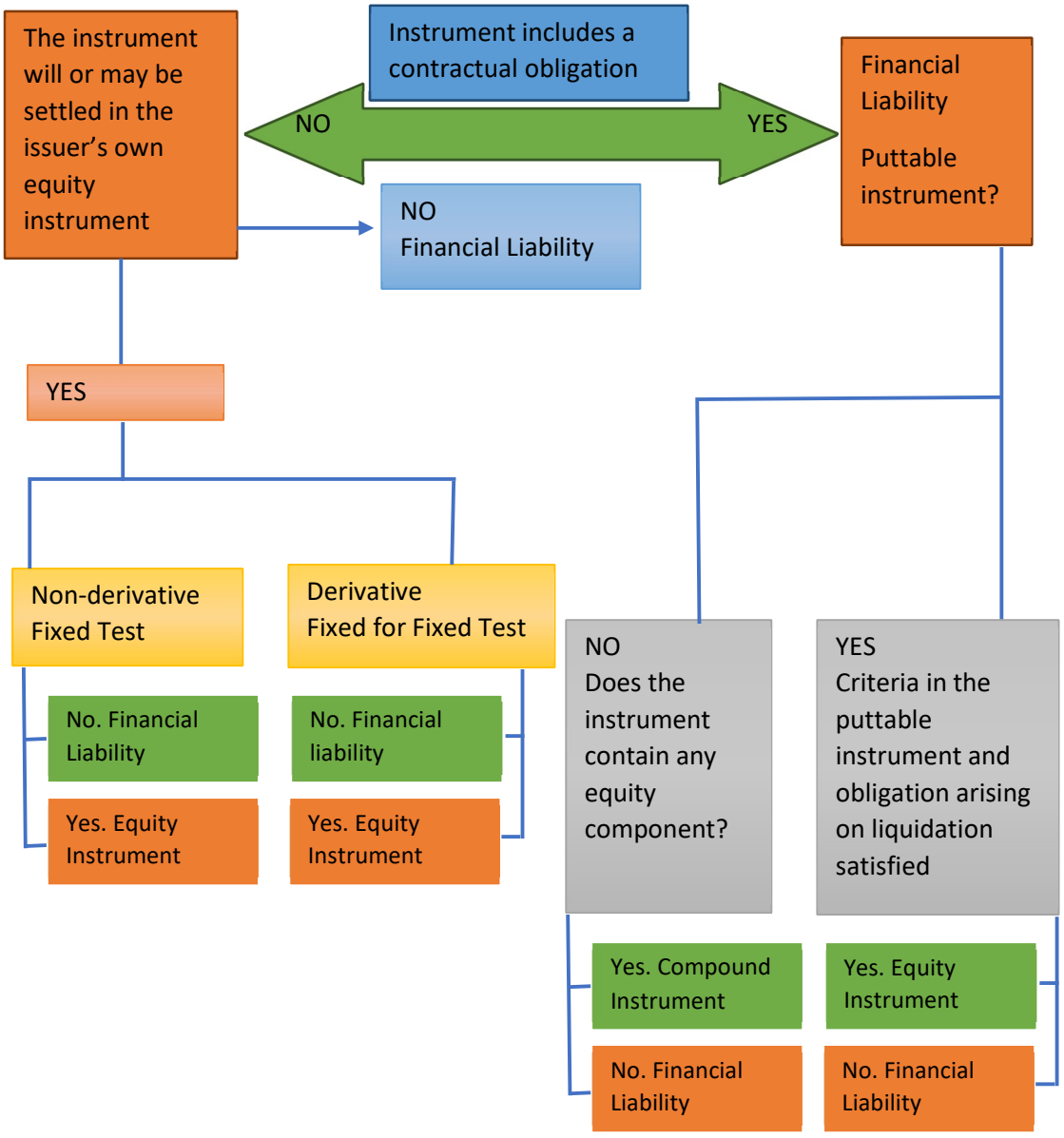
(b) If the instrument will or may be settled in the issuer’s own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

As shown in Figure 3, if a financial instrument contains a contractual obligation, it should be classified as a financial liability. However, before making this classification, it should be examined whether the financial instrument is a puttable instrument. If the financial instrument does not contain a contractual obligation, we will need to check the second condition to be able to classify it as an equity instrument.

Figure 3: Financial Liability and Equity Instrument Classification



But first, let's understand the contractual obligation issue. Now assume that there are two parties: A and B. A gave CU 1,000 to B, and B gave a written document to A in return. In the document it is stated that:

- B will deliver CU 1,100 one year later to A.

- One year later B will deliver 100 shares of Entity C and get 10 shares of Entity D from A. Shares of Entity C are more valuable than the shares of Entity D. In both conditions there are some obligations that arise from the document. In this case, it is not an equity instrument.

Now assume that the written document does not include any aforementioned contractual obligations. It states that party B will make the payment with its own stock. In this case, the conditions under which the shares will be provided must be determined. As can be seen in Figure 3, a test (fixed test or fixed for fixed test) should be applied for classification according to whether the issued financial instrument is derivative or non-derivative. These tests are based on the financial liability classification principles specified in IAS 32.11.

Fixed test bases on this statement (IAS 32.11) *"a non-derivative for which the entity is or may be obliged to deliver **a variable** number of the entity's own equity instruments''.* Accordingly, if an entity makes a payment with a non-derivative instrument and the entity issues a variable number of equity instruments for this payment, it will fail the fixed test and the financial instrument will be classified as financial liability.

If there is a derivative instrument, then a fixed for fixed test is used which is based on this statement (IAS 32.11) *"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."* If there is an entity that issues a derivative instrument and pays cash to the investor for derivative on the expiration date or gives a fixed number of equity instruments, then this derivative instrument is considered to have passed the fixed for fixed test and is classified as an equity instrument.

It was stated that if a financial instrument contains a contractual obligation, it should be classified as a financial liability. However, as an exception for financial liability, instruments that include obligations of a puttable instrument are classified as equity instruments if they have the following features (IAS 32. 16A):

(a) Instrument holder entitles a pro rata share of the entity's net assets on liquidation.

(b) Being a financial instrument in a class that comes after all other financial instrument classes.

(c) All financial instruments in a class that comes after all other financial instrument classes have similar characteristics.

(d) Only contractual obligation for the issuer is to repurchase or redeem the instrument for cash or another financial asset.

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument

Now let's return to our toy shop example. The first alternative was "The toy shop will pay with the shares of another business valuing CU 10,000". There is a contractual obligation in this alternative. The toy shop accepts the obligation to provide a financial asset to the toy manufacturer. Due to the existence of a contractual obligation, this financial instrument should be classified as a financial liability.

The second alternative was "The toy shop will pay with its own share totalling CU 10,000". There is no contractual obligation in this alternative, so the second condition should be considered for equity instruments. In this alternative the instrument will be settled in the issuer's own equity instruments. In this alternative, the toy shop will issue a variable number of shares depending on the price of its

own share on the maturity date. That will not satisfy the equity instrument classification, so this should also be classified as financial liability.

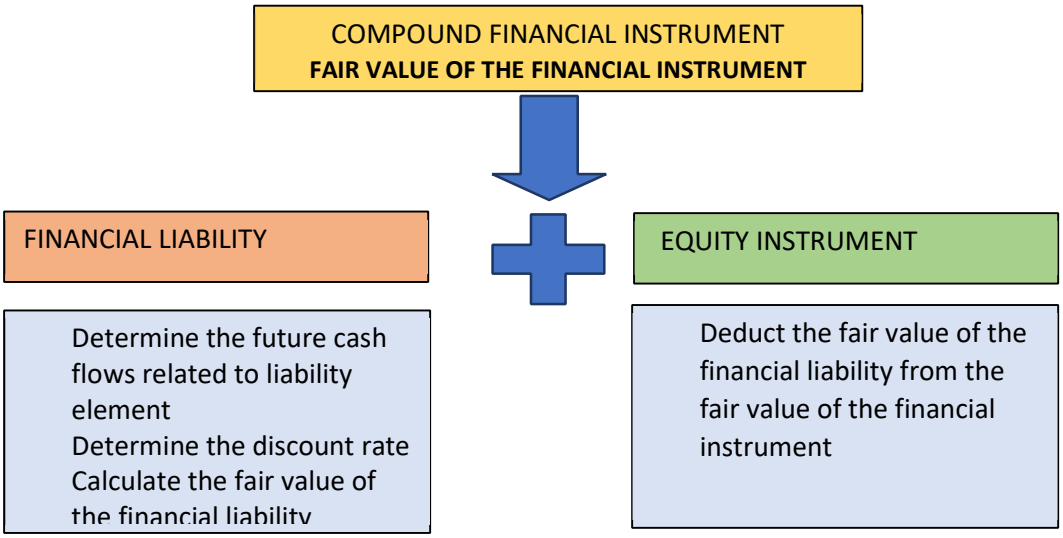
The third alternative was “The toy shop will pay with its 50 own shares”. This alternative also does not include any contractual obligation. This alternative includes a non-derivative with a contractual obligation for the issuer to deliver a fixed number of its own equity instruments. Then this instrument should be classified as an equity instrument.

COMPOUND INSTRUMENTS

Sometimes financial instruments may have both financial liability and equity instrument elements at the same time. These are called compound instruments. Convertible bonds are an example of compound instruments. Financial liability and equity instrument elements in compound financial instruments should be classified separately.

The basic approach in determining the value of a financial liability and equity instrument in compound instruments is to determine the financial liability value first and to accept the remaining residual value as the equity instrument value. As presented in Figure 4, residual value is the difference between the fair value of the compound financial instrument and its financial liability value. Such an approach has been adopted because it is relatively easy to determine the future cash flows and discount rate of the financial liability element.

Figure 4: Compound Financial Instrument Classification



Doru Co. has issued a convertible bond with a nominal value of CU 500,000, a maturity of 4 years and an interest rate of 6%. According to the contract, each bond worth CU 1,000 could be converted into 100 Doru Co. shares. This convertible bond was sold for a total of CU 500,000. A bond with similar characteristics sold in the same period yields 10% interest. How should this bond be presented in the financial statements of Doru Co.?

The starting point for this question is the principle of substance over form. Even if convertible bonds are legally classified as bonds, it should be evaluated whether this financial instrument is a financial debt or an equity instrument. Compound bonds are instruments that provide more than one economic

benefit to its owner in the issuing organisation. The financial instrument contains a contractual obligation. However, it is a puttable instrument, and this instrument contains an equity component.

Doru Co. has gained an advantage by selling this bond with the option to convert it into shares. While under normal circumstances it would issue a similar bond with 10% interest, Doru Co. borrowed 6% due to the conversion option. This difference in interest rates is due to the equity instrument value in this financial instrument.

For this compound bond, first of all, the financial liability value of the bond must be calculated. This calculation will be made by finding the present value of future cash flows of the bond. However, when calculating the present value, 10% should be used instead of the 6% discount rate. Because the difference between the two rates is due to the compound bond offering an equity instrument. The investor is willing to pay 6% interest instead of 10% interest due to the equity instrument offered. The investor hopes that the loss in interest rates will be compensated by the gains to be made from the equity instrument that will be offered in the future. Afterwards, the value of equity option will be found by subtracting the calculated financial liability value from the CU500,000 value of the financial instrument.

Table 1: Present Value of Cash Flows

Periods		1	2	3	4
Principal Repayment					500,000
Annual Interest		30,000	30,000	30,000	30,000
Total Cash Flows		30,000	30,000	30,000	530,000
Present Value of Cash Flows (discounted by 10%)	436,602	27,273	24,793	22,539	361,997

The financial liability value, as shown in Table 1, calculated by discounting future cash flows from the compound bond with 10%, is CU 436,602 (results are rounded). This amount should be subtracted from the value of the financial instrument. The financial instrument was sold for CU 500,000 at the relevant date (Note: could have been sold for a different amount). In this case, the equity instrument value is calculated as follows:

Financial instrument	CU 500,000
(-) Financial Liability	436,602
= Equity Instrument	63,398

The seller will make a record of the sale of this financial instrument as follows.

Dr. Cash	500,000	
Cr. Financial Liability		436,602
Cr. Equity Instrument		63,398

The buyer will make the following record.

Dr. Financial Asset	500,000	
Cr. Cash		500,000

TREASURY SHARES

If an entity buys its own shares, can it classify them as financial assets? The answer to this question will be no. When businesses reacquire their own shares, those are not traded as financial assets, they must be deducted from equity. The entity cannot report gains or losses due to the acquisition of its own shares.

Suppose that Entity A buys CU10,000 of its own stock on the stock exchange. Entity A will not classify these shares as financial assets, but rather these CU10,000 shares would reduce Entity A's equity by CU10,000.

In a consolidated group, the entity or members of the consolidated group may also purchase treasury shares. In that case consideration paid or received should be recognized directly in the equity. If an entity holds some treasury shares their amount should be disclosed.

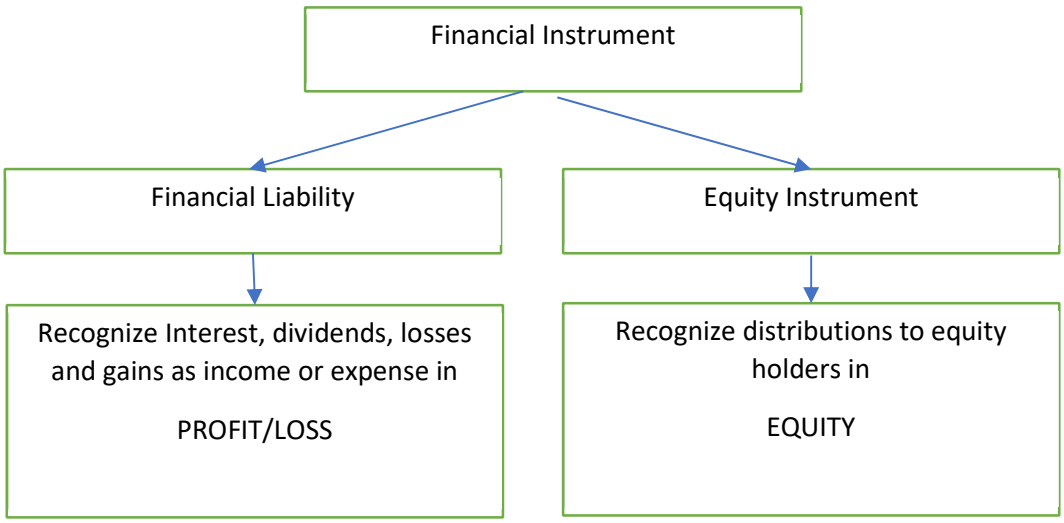
Suppose that Entity A has a subsidiary named Entity B. Suppose that Entity B buys Entity A's stock worth CU10,000 on the stock exchange. Two different situations will arise regarding Entity B's reporting of these stocks. Entity A's shares will be reported as financial assets in Entity B's separate financial statements. However, in entity A's consolidated financial statements, these amounts will be deducted from equity.

INTEREST, DIVIDENDS, LOSSES AND GAINS

When a business acquires a financial asset, it will be exposed to various cash flows related to that financial instrument. These cash flows will generate various income elements such as interest and dividends. In addition, changes in the value of the financial instrument will also cause loss or gain. The principle regarding these elements has been determined as follows (IAS 32. 5):

As presented in Figure 5, interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.

Figure 5: Accounting for Interest, Dividends, Losses and Gains



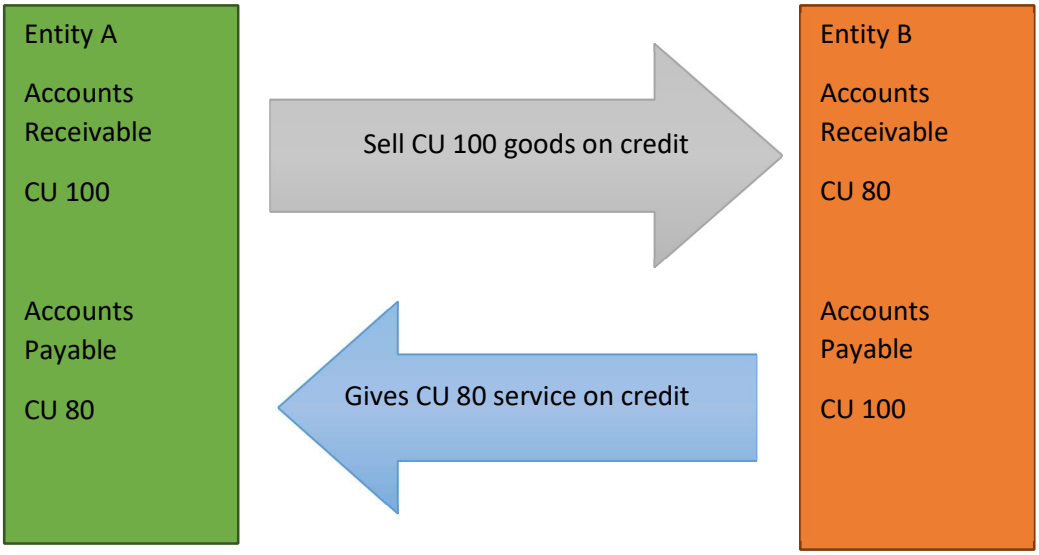
OFFSETTING

Offsetting is the presentation of a financial liability and financial asset as a single net amount (as a liability or as an asset) in the statement of financial position.

Two criteria are important for offsetting. These are;

- Legal enforceable right to set off the recognized amounts
- Intention to settle on a net basis.

Figure 6: Offsetting Financial Liabilities and Financial Assets



To understand offsetting, let's consider the transactions between two companies shown in Figure 6. Let Entity A be a merchandising entity and Entity B a service business. Entity A has sold merchandise worth CU100 to entity B on credit. Entity B provided services to Entity A and did not collect its receivable of CU 80. In this case, Entity A has CU 100 receivables from Entity B, and CU 80 liability to Entity B. If Entity A collects CU 20 from Entity B, the debt-credit relationship between A and B will be legally closed. This is also the intention of Entity A. In this case, Entity A will report only receivables worth CU 20 in its statement of financial position as a result of these transactions. Otherwise, Entity A must report both receivables worth CU 100 and liability worth CU 80 in its statement of financial position.

EXAMPLE

Let's have a more detailed example of the presentation of financial instruments. Murat Co. operates in the agriculture sector. The entity seeks debt to finance a new investment. The entity plans to buy a new field and grow corn on it. Murat Co. needs CU 250,000 for this investment. At the end of one year, the business plans to produce 500 tons of corn and sell a ton of corn for CU 100. Murat Co. has negotiated with a creditor who can finance this investment. As a result of the negotiations, various financing alternatives were evaluated, and the following possible agreements were planned.

a. Creditor will lend CU 250,000 and will receive 300,000 cash a year later.

b. Creditor will lend CU 250,000 and will receive 300 tons of corn a year later.
c. Creditor will lend CU 250,000 and will receive Murat's shares totalling CU 300,000 a year later.
d. Creditor will lend CU 250,000 and will get Murat's 10,000 shares a year later.
e. Creditor will lend CU 250,000 and will receive CU 270,000 or 10,000 shares of Murat a year later.

SOLUTION

In order to classify the alternatives presented to us in the question as financial debt or equity instruments, the existence of contractual obligations should be investigated in the first place. Contractual obligations are;

- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable for the issuer.

If there is any contractual obligation, then we classify the instrument as a financial liability.

a. Murat Co. has an obligation of delivering cash amounting to CU 300,000 in the first alternative. In this case, this contract should be classified as a financial liability.
b. Murat Co.'s obligation in this alternative is to deliver 300 tons of corn. Obligation does not include any cash or financial asset delivery or exchange of financial assets or liabilities. In addition, the obligation is not settled with an agreement that includes Murat Co's stocks. In this case, there is no financial liability or equity instrument element.
c. There is no contractual obligation for Murat Co in this alternative. However, instruments will be settled in the issuer's own equity instruments. The instrument is a non-derivative one. Then in order to classify it as an equity instrument it should include **no contractual obligation**s for the issuer to deliver a variable number of its own equity instruments. However, it is uncertain how many shares Murat will give in this alternative. The number of the shares varies depending on the stock value on the maturity. Then it should be classified as a financial liability.
d. Again, there is no contractual obligation for Murat Co., and the instrument is settled in Murat Co.'s own equity instruments. Here, unlike the previous alternative, the number of stocks is not variable. Murat Co. It will issue 10,000 shares. Then it is an equity instrument.
e. This alternative has a contractual obligation. However, in this contract, there is also the possibility that the contract will be settled with Murat Co's own equity instruments. There is an advantageous situation due to the possibility of buying an equity instrument in this alternative. Under normal conditions, the related obligation can be closed with CU 300,000 (see alternative a), due to the opportunity to get equity, the obligation can be closed with CU 270,000 in this alternative. There is a compound financial instrument. The financial instrument should be separated into financial liability and equity instruments.