



Financial Instruments in Modern Accounting Management

Gheorghe LEPĂDATU

"Dimitrie Cantemir" Christian University, Bucharest Faculty of Finance, Banking and Accounting, E-mail: cilezbujor@yahoo.com

Abstract *The provision of transparent and useful information on market participants and their transaction is essential for an orderly and efficient market, and it is one of the most important preconditions for imposing market discipline. Left to themselves, markets may not generate sufficient levels of disclosure. Market forces would normally balance the marginal benefits and marginal costs of additional information disclosure and the end result may not be what the market participants really need.*

Key words:

Financial statements, balance sheet, income statements, cash flow statement, IAS/IFRS

JEL Codes:

M41

1. Introduction

Financial and capital market liberalization trends of the 1980s which brought increasing volatility in financial markets, increased the need for information as a means to ensure financial stability. In the 1990s, as financial and capital market liberalization increased, there has been mounting pressure for the provision of useful information in both the financial and private sectors; disclosure requirements now dictate the quality and quantity of information that must be provided to the market participants and the general public. Because the provision of information is essential to promote the stability of the markets, regulatory authorities also view the *quality of information* as a high priority. Once the quality of information required by market participants and regulatory authorities is improved, entities would do well to improve their own internal information system so as to develop a reputation for providing good quality information.

2. Literature review

Literature in the field of financial instruments is topical and very large. Superior accounting schools in Bucharest, Iasi, Cluj, but also teachers with interests in the field of financial instruments have contributed to the development of implementation of IFRS in economics, having a special importance in making decision. For the preparation of this material was analyzed the

treaties, but also the practical experience in the field of accounting applied in industry, who contributed to the completion of this study.

3. Purpose and applicability of the standards

The public disclosure normally involves publication of relevant qualitative and quantitative information in annual financial reports, which are often supplemented by interim financial statements and other relevant information. The provision of information involves cost: when determining disclosure requirement, its usefulness for the public must be evaluated against the cost to be borne by the enterprise.

The timing of disclosure is also important. Disclosure of negative information to a public not yet sufficiently sophisticated to interpret the information may damage the enterprise in question. When information is of inadequate quality and/or the user are not deemed capable to properly interpret the information, public disclosure requirements should be carefully phase in and progressively tightened. In the long run, a full disclosure regime is beneficial, even if some problems are experienced in the short term, because the cost to the financial system of not being transparent is ultimately higher than the cost of being transparent.

IAS 32 and 39 were issued as separate standard but are applied in practice as a unit because they deal with exactly the same accounting

phenomenon. IAS 39, which deals with the Recognition and Measurement issues of financial instruments, also contains some supplementary disclosures to those required by IAS 32. These requirements are listed in this chapter in order to provide a comprehensive list of all the Disclosure and Presentation aspects related to financial instruments.

User need information that will enhance their understanding of the significance of on – and off – balance sheet financial instruments regarding an enterprise's financial position, performance and cash flows, and the assessment of the amounts, timing, and certainty of future cash flows associated with those instruments. This IAS:

- Prescribes requirements for the *presentation* of on balance sheet financial instruments.
- Identifies information for the should be *disclosed* about both on – balance sheet (recognized) and off – balance sheet (unrecognized) financial instruments.

The IAS deals with *all types of financial instruments*, both recognized and unrecognized. A *financial instrument* is any contract that gives rise to both a financial asset of one enterprise and a financial liability on equity instrument of another.

4. Accounting treatment

A *financial asset* is any asset that is:

- cash (e.g. deposit at a bank),
- a contractual right to receive cash or financial asset (e.g. a debtor and derivative instrument),
- a contractual right to exchange financial instrument under potentially favorable conditions, **or**
- an equity instrument of another enterprise (e.g. investment in shares).

Physical assets (e.g. inventories and patents) are not financial assets, as they do not give rise to a present right to receive cash or other financial assets.

A *financial liability* is a contractual obligation to:

- deliver any financial assets (e.g. creditor and derivative instrument), *or*
- exchange financial instruments under potentially unfavorable condition.

Liabilities imposed by statutory requirements (e.g. income taxes) are not financial liabilities because they are not contractual.

An *equity instrument* is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities. An obligation to issue an equity instrument is not a financial liability because it results in an increase in equity and cannot result in a loss to the enterprise.

The issuer of a financial instrument classifies it or components as a liability or as equity in accordance with the:

- Substance of the contractual arrangement on initial recognition
- Definitions above

Substance over form governs the classification (e.g. redeemable preferred share creates an obligation, which makes it a financial liability rather than equity).

The issuer of a *compound financial instrument* that contains *both* a liability and equity element (e.g. convertible bonds) should classify the instrument's component parts separately:

- Total amount – liability portion = equity portion
- Equity valuation + liability = total value. Assign carrying amount *pro rata* to the values so established.

Once so classified, the classification is not change even if economic circumstances change. No gain or loss arises from recognizing and presenting the parts separately.

Interest, dividends, losses, and gain relating to a financial liability should be reported in the income statement as expense or income. Distribution to holders of an equity instrument should be debited *directly* to equity. The classification of the financial instrument determines the accounting treatment of the mentioned above:

- Dividends on share classified as liability would thus be classified as expense in the same way as interest payments on a loan. Furthermore, such dividends would have to be accrued over time.
- Gains and losses (presumably premiums and discounts) on redemption or financing of instruments classified as liabilities are reported in the *income statement*, while gains and losses on instruments classified as *equity* of the issuer are reported as movements in equity.

A financial asset and financial liability should be **offset** only when:

- a legal enforceable right to set – off exists, and
- there is an intention either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

5. Analyse of results

Risk management policies

Describe the financial risk management objectives and policies, including the following:

- Policy for hedging each major type of forecasted transaction
- Price risk (currency, interest rate, and maker risk)

Principal/notional amounts
Dates of maturities or execution
Early settlement option and period's
Conversion options

Amounts and timing of future receipts or payments.

- Accounting policies, including recognition criteria and measurement bases, such as:
- Method and assumptions applied in estimating fair value, separately for classes of financial assets and financial liabilities
- Whether gains/losses on remeasurement of available – for – sale financial assets are included in profit or loss for the period or recognized directly in equity
- Whether, „regular way” financial asset purchases and sales are accounted for at trade date or settlement date (for **each** of the categories of financial assets).

Interest rate risk

For each class of **financial asset** and **financial liability**, disclose:

- Contractual repricing or maturity dates, whichever dates are earlier
- Effective interest rates
- Other information about exposure to interest rate risk

Credit risk

For each class of **financial asset**, disclose:

- The amount that best represents its maximum credit risk exposure **without** taking account of the fair value of collateral
- Significant concentration of credit risk
- Other information about exposure to credit risk

- Credit risk
- Liquidity risk
- Cash flow risk

Terms, condition, and accounting policies

- For each class of **financial asset**, **financial liability**, and **equity instrument** disclose: Information about the extend and nature, including significant terms and conditions that may affect the amount, timing, and certainty of future cash flows, for example:

Rates or amounts of interest and dividends
Collateral held
Foreign currency information
Covenants, etc.

Fair value

For each class of **financial asset** and **financial liability**, disclose information about fair value:

- Fair value for trade instrument:
- Asset held or liability to be issued: bid price
- Asset to be acquired or liability held: offer price
- For an instrument not traded, it may be appropriate to disclose a range of amounts.
- when impracticable to determine the fair value reliably, the **fact** is disclosed together with **information** about the principal characteristics of the underlying financial instrument pertinent to its fair value

Financial assets in excess of fair value

For **financial assets** carried in excess of fair value, disclose:

- Carrying amount and fair value, individually or for appropriate grouping of those assets.
- Reasons for not reducing the carrying amount, including evidence supporting recoverability of the amount

Hedging

Disclose **separately** for designated fair value hedges, cash flow hedges and hedges and hedges of a net investment in a foreign entity:

- Description of the hedge
- Description of financial instrument (s) designated as hedge, and its fair value(s)
- Nature of the risk being hedged.

- For hedges of forecasted transaction:
 - The period in which it is expected to occur
 - When it is expected to enter into determination of net profit or loss
 - Description of any forecasted transaction for which hedge accounting had previously been used but is not longer expected to occur
- For gains/losses related to cash flow hedges that have been recognized directly in equity (through the statement of changes in equity):
 - Amount recognized in equity.
 - Amount removed from equity to net profit or loss for the period
 - Amount removed from equity and allocated to the carrying amount of the asset or liability in a hedged forecasted transaction

Additional disclosures relating to financial instruments

- For gain/losses from remeasuring available – for – sale financial assets that have been recognized in equity:
 - Amount recognized
 - Amount removed from equity to net profit or loss for the period
- Significant items of income, gains, and losses resulting from financial assets and financial liabilities
- Interest income and expense shown separately
- Realized and unrealized amounts shown separately
- Gains and losses from derecognition shown separately from those resulting from fair value adjustments
- Amount of interest income accrued on impaired loans shown separately
- For financial assets measured at amortized cost:
 - A disclosure of that fact
- A description of the financial assets
- The carrying of the financial assets
- An explanation of why fair value cannot be measured reliably.
- A range of estimates within which fair value is highly likely to lie
- Disclosure of the following when these assets are sold:
 - The fact
 - Carrying amount at time of sale
 - Gain or loss recognized
- Reason for reclassification of any financial asset to be reported at amortized cost rather than fair value
- For an impairment loss or reversal of such loss:
 - The nature of the loss
 - The amount
- The carrying amount of financial assets pledged as collateral for liabilities and any terms and conditions relating to the pledged assets.
- For securitization or repurchase agreements:
 - Nature and extent of transactions.
 - Description of collateral and quantitative information about key assumptions used in calculating fair values
 - Whether the financial assets have been derecognized
- A lender discloses:
 - The fair value of collateral accepted and that it is permitted to sell or repledge in absence of default.
 - The fair value of collateral that it has sold or repledged.
 - Any significant terms and conditions associated with the use of collateral

CASE STUDY

FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION

The extracts below were taken from the annual reports of several enterprises.
They illustrate some of the disclosure requirements required by IAS 32 and 39

The following extract from the **Bell Atlantic 2007 Annual Report** illustrates the disclosure of *risk management policies and interest rate risk*

FINANCIAL INSTRUMENT

Derivates

We limit our use of derivatives to managing risk that could negatively impact our financing and operating flexibility, making cash flows more stable over the long run and achieving saving over other means of financing. Our risk management strategy is designed to protect against adverse change in foreign exchange rates, interest rates and corporate tax rates, and to otherwise facilitate our financing strategy. We use several types of derivatives in managing these risks, including foreign currency forwards and options, interest rate swap agreements, interest rate caps and floors, and basis swap agreements. Derivative agreements are linked to specific liabilities or assets and hedge the related economic exposures. We do not hold derivatives for trading purposes. In 1997 and 1996, we recognized income of \$ 17.3 million and \$ 12.7 million before taxes in our statements of income related to all of our risk management activities.

Interest Rate Risk Management

The following table provides additional information about our interest rate swap agreements, interest rate caps and floor, and basis swap agreements. Certain of our interest rate swap agreements (included below as “Foreign Currency / Interest Rate Swaps”) also contain a foreign exchange component which has been described in the “Foreign Exchange Risk Management” section below. We use these interest rate swap agreements to hedge the value of certain international investments. The agreements generally require us to receive payments based on fixed interest rates and make payment based on variable interest rates. The structured note swap agreements convert several structured medium – term notes to conventional fixed rate liabilities while reducing financing costs. The effective fixed interest rates on these notes averaged 6.1 percent and 6.2 percent at December 31, 1997 and 1996. Other interest rate swap agreements, which sometimes incorporate options, and interest rate caps and floor are all used to adjust the interest rate profile of our debt portfolio and allow us to achieve a targeted mix of floating and fixed rate debt. The basis swap agreements require us to our leveraged lease portfolio against adverse changes in corporate tax rates. The agreements require us to receive payments based on an interest rate index (LIBOR – based) and make payments based on a tax – exempt market index (J.J. Kenney). We account for these basis swap agreements at fair value and recognized income of \$ 4.2 million and \$ 20.2 million in 1997 and 1996 related to mark – to – marker adjustments.

The notional amounts shown below are used to calculate interest payments to be exchange. These amounts are not actually paid or received, not are they a measure of our potential gains or losses from market risks. They do not represent our exposure in the event of nonperformance by counterparty or our future cash requirements. Our financial instruments are grouped below based on the nature of the hedging activity.

On December 31	Notional Amount \$	Maturities	(\$ in Million)	
			Receive \$	Pay (%)
Interest Rate Swap Agreements:				
<i>Foreign Currency/Interest Rate Swaps</i>				
2014	375.4	.....	4.5	6.2
2013	928.4	.....	3.3	5.9
<i>Other Interest Rate Swaps</i>				
<i>Pay Fixed</i>				
2014	260.0	.....	5.7	5.9
2013	221.2	.....	5.7	6.0
<i>Pay Variable</i>				
2014	783.7	.....	6.6	6.1

2013	530.7	.....	6.5	6.4
Structured Note Swaps:				
2014	60.0	.....	
2013	105.0	.....	
Interest Rate Cap/Floor Agreements				
2014	262.0	.....	
2013	140.0	.....	
Basic Swap Agreements:				
2014	1,001.0	.....	
2013	1,001.0	.....	

The following extract from the **Bank Corporation 1999 Annual Report** illustrates the disclosure of *fair value of financial instruments*

FINANCIAL ASSETS

Assets for Which Fair Value Approximates Carrying Value: The fair values of certain financial assets carried at cost, including cash and amounts due from banks, deposits with banks, Federal funds sold and securities purchased under resale agreements, due from customers on acceptances, short – term receivable and accrued interest receivable, are considered to approximate their respective carrying values due to their short – term nature and generally negligible credit losses.

Trading Assets: Bank carries trading assets, which included debt and equity instruments as well as the positive fair value on derivative and foreign exchange instruments, at estimated fair value.

Securities: Available – for – sale securities and related derivative contracts are carried at fair value. Held – to – maturity securities are carried at amortized cost. The fair value of actively – traded securities is determined by the secondary market, while the fair value for nonactively traded securities is based on independent broker quotation.

Loans: Loans are valued using methodologies suitable for each type of loan.

The fair value of bank's commercial loan portfolio is estimated by assessing the two main risk components of the portfolio: credit and interest. The estimated cash flows are adjusted to reflect the inherent credit risk and then are discounted, using a rate appropriate for each maturity that incorporates the effects of interest rate change. Generally, emerging market loans are valued based on secondary market prices.

For consumer installment loans (including auto financings) and residential mortgages for which market rates for comparable loans are readily available, the fair values are estimated by discounting cash flows, adjusted for prepayments. The discount rates used for consumer installment loans are current rates offered by commercial banks and thrifts. For residential mortgages, secondary market yields for comparable MBSs, adjusted for risk are used. The fair value of credit card receivables is estimated by discounting expected cash flow. The discount rates used for credit card receivable incorporate the effects of interest rate changes only, since the estimated cash flows are adjusted for credit risk.

Other Assets: This caption consists primarily of private equity investments. Nonpublic investments are carried at cost, which is viewed as an approximation of fair value. The carrying value of nonpublic investments is adjusted for holdings in which a subsequent investment by an unaffiliated party indicates a valuation in excess of cost and for holding for which evidence of an other – than – temporary decline in value exists.

Public securities held by bank Capital Partners are valued at quoted market prices (prior to any liquidity discounts) for the purpose of fair value disclosure required by SFAS 107.

FINANCIAL LIABILITIES

Liabilities for Which Fair Value Approximates Carrying Value: SFAS 107 requires that the fair value disclosed for deposit liabilities with no stated maturity (i.e. demand, savings and certain money market deposits) be equal to carrying value. SFAS 107 does not allow for the recognition of the inherent funding value of these instruments. The fair value of foreign deposits, Federal funds purchased and securities sold under repurchase agreements, commercial paper, other borrowed funds, and acceptances outstanding, and accounts payable, and accrued liabilities are considered to approximate their respective carrying values due to their short – term nature.

Domestic Time Deposits: the fair of time deposits is estimates by discounting cash flows based on contractual maturities at the interest rates for raising funds of similar maturity.

Trading Liabilities: Bank carries trading liabilities, which include securities sold, not yet purchased, structured notes, and derivative and foreign exchange contracts, at estimated fair value.

6. Conclusions

The fair value financial instruments is the current amount that would be exchange between willing parties (other than in a forced sale or liquidation), and is best evidenced by a quoted market price, if one exists.

Quoted market prices are not available for all banks financial instruments. As a result, the fair values presented are estimates derived using present value or other valuation techniques and may not be indicative of net realizable value. In addition, the calculation of estimated fair value is based on market conditions at a specific point in time and may not be reflective of future fair values.

Certain financial instruments and all nonfinancial instruments are excluded from the scope of SFAS 107. Accordingly, the fair value disclosures required by SFAS 107 provide only a partial estimate of the fair value of bank. For example, the values associated with the various ongoing businesses that bank operates are excluded. Bank has developed long – term relationship with its customers through its deposit base and its credit card accounts, commonly referred to as core deposit intangibles and credit card relationship. In the opinion of management, these items in the aggregate add significant value to bank, but fair value is not disclosed in this Note.

Fair values among financial institutions are not comparable due to the wide range of permitted valuation techniques and numerous estimates that must be made. This lack of an objective valuation standard introduces a great degree of subjectivity to these derived or estimated fair values. Therefore, readers are cautioned in using this information for purposes of evaluating the financial condition of bank, compared with other financial institutions.

Bibliography:

Epstein, B. J. and A. A. Márza,	<i>Interpretation and Application of International Accounting Standards</i> , 1998, New York, John Wiley & Sons
Hattingh C. P.	<i>Financial Accounting Course – One Page Summaries</i> , Randburg: PC Finance Research CC
Levis, R. and D. Pendrill	<i>Advanced Financial Accounting</i> , 40 th ed. London, Pitman Publishing
Oppermann, H. R. B., S. F. Booyesen, M. Koen, C.S. Binnekade, and J. G.I. Oberholster,	<i>Accounting Standards</i> , 7 th ed. Cape Town, Juta
School of Accountancy	1995, <i>The 1995 QE</i> , Pretoria University of Pretoria, 1997
School of Accountancy	<i>The 1995 QE</i> , Pretoria University of Pretoria., 1995
Vorster, Q., M. Koen, and C. Koornhof	<i>Descriptive Accounting</i> , 5 th ed. Durban, Butterworths. 2000