FINANCIAL REPORTING FACULTY

FAQ

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BASIC AND OTHER FINANCIAL INSTRUMENTS

The Financial Reporting Faculty answers your initial questions on accounting for basic and other financial instruments under the new UK GAAP regime

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* includes requirements in relation to financial instruments that are significantly different from those of the UK standards it replaces. Many entities are likely to find that the requirements of Sections 11 and 12 of the standard will pose a significant challenge, both on transition to the new regime and when applying it on an ongoing basis.

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This document does not consider hedge accounting under FRS 102. See our separate FAQs on *Hedge Accounting under FRS 102* for more details.

1. What are financial instruments?

A financial instrument is defined by FRS 102 as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include common items such as cash, bank balances, debtors, creditors and bank loans, as well as more complex items such as derivatives and asset-backed securities.

2. Where in FRS 102 can I find guidance on accounting for financial instruments?

Much of the guidance on accounting for financial instruments can be found in Sections 11 and 12 of FRS 102, which divide financial instruments into 'basic' and 'other' instruments. The former are mostly measured at amortised cost, while the latter are mostly measured at fair value, with movements recognised in profit or loss.

3. What are 'basic' financial instruments?

Paragraph 11.8 of FRS 102 provides a list of basic financial instruments, including:

- cash;
- debt instruments with relatively straightforward terms that meet certain criteria of paragraph 11.9 of FRS 102, including most trade debtors and creditors and many relatively simple bank loans;
- investments in many ordinary and preference shares; and
- certain loan commitments.

4. What are 'other' financial instruments?

Financial instruments that fail to qualify as basic will be classified as other. Other financial instruments include:

- debt instruments that do not meet the criteria of paragraph 11.9 of FRS 102;
- investments in puttable ordinary or preference shares ie, shares that the holder has the right, but not the obligation, to return to the issuer in exchange for cash or other financial assets;
- investments in convertible preference shares; and
- derivatives.

5. How do I work out if a debt instrument qualifies as a 'basic' instrument?

Paragraph 11.9 of FRS 102 holds the key to determining whether a debt instrument will be classified as basic or other. It sets out detailed criteria relating to the contractual return to the holder, variations of the return to the holder, detrimental terms, prepayment terms and extension terms. Care should be taken as some common and straightforward contractual terms may result in loans and other debt instruments being classified as other.

6. How are debtors and creditors accounted for?

When goods are sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that customer. Likewise, when goods are purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier. In such cases, the amount recognised would normally be the invoice amount.

A transaction is, however, considered to be a financing transaction when payment for goods or services is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate. In such instances, a receivable or payable is initially recognised at the present value of the future payments, discounted at a market rate of interest for a similar debt

instrument. At the end of each subsequent reporting period, the receivable or payable will be measured at amortised cost using the effective interest method (see Q12 below).

7. How are investments in ordinary and preference shares accounted for?

The treatment is the same regardless of whether equity instruments are classified as basic or other. If they are publicly traded or their fair value can otherwise be reliably measured, investments in ordinary or preference shares are measured at fair value, with changes in fair value recognised in profit or loss. Otherwise, they are measured at cost less impairment. This is a significant change from previous UK GAAP.

8. How are bank loans accounted for?

All bank loans payable are financing transactions. They are therefore recognised initially at the present value of cash payable to the bank ie, including interest payments and repayment of principal.

Bank loans that qualify as basic are subsequently measured at amortised cost. Bank loans classified as other are subsequently measured at fair value with movements recognised in profit or loss. Those entities with loans classified as other will find that they are accounted for very differently than under previous UK GAAP.

9. How are intercompany loans accounted for?

There are no special requirements for loans between group companies. Many intercompany loans will meet the criteria to be classified as basic instruments. As such they will generally be measured at amortised cost. Classification as basic should not, however, be assumed without a thorough analysis of all contractual terms.

The application of the standard will mean that a loan with fixed maturity at zero or below market interest rates that qualifies as a basic instrument will be recorded on initial recognition at less than its nominal amount. This difference will generally be accounted for as a capital contribution or distribution. This is a significant change.

10. How are derivatives accounted for?

Derivatives, for example interest rate swaps and forward foreign currency contracts, are measured at fair value under FRS 102, with changes in fair value recognised in profit or loss. This is again a significant change, as under previous UK GAAP such instruments were typically off-balance sheet with gains and losses normally recognised on settlement.

11. How is fair value calculated?

The following hierarchy should be used to estimate fair value:

- the quoted price for an identical asset in an active market; or
- when quoted prices are not available, it may be possible to use the price of a recent transaction for an identical asset to provide evidence of fair value; or
- if neither of the above is available, valuation techniques – such as discounted cash flow analysis or option pricing models – should be used.

In some cases, establishing fair value will be relatively straightforward, particularly when quoted market prices are available. However, it will be much more challenging in other instances. In such cases entities will need to consider how to obtain a valuation eg, asking the bank or using a valuation package.

12. How is amortised cost calculated?

Under the amortised cost method, the carrying value of a financial asset or financial liability is measured at each reporting date at the net of:

- the amount initially recognised;
- minus any repayments of principal;
- plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;
- minus any interest paid;
- minus, in the case of a financial asset, any reduction for impairment or uncollectability.

The effective interest method is a way of calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or expense over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life – or a shorter period when appropriate – of the financial instrument to the carrying amount of the financial asset or financial liability.

This approach is similar to the one used under FRS 4 *Capital Instruments*, but there can be some differences.

13. How often do I need to assess financial assets for impairment?

At the end of each reporting period, an entity must assess whether there is objective evidence of impairment of any financial assets that are held at cost or amortised cost. When objective evidence of impairment exists, an impairment loss must be recognised immediately in profit or loss.

14. When are financial assets and financial liabilities derecognised?

The standard includes detailed requirements relating to the derecognition of financial assets and financial liabilities that will be particularly of interest to entities involved in debt factoring or the renegotiation of the terms of loans or other debt instruments.

In brief, a financial asset is derecognised when it is settled or when the contractual rights to its cash flows expire eg, when a debtor pays what is owed or when the holder no longer has any entitlement to future cash flows. A financial liability is derecognised when it is wholly or partially extinguished eg, when the obligation is discharged, cancelled or expires.

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