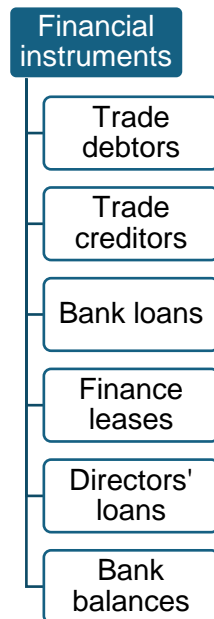


Disclosing accounting policies: financial instruments

(Lecture A852 – 9.45 minutes)

Pretty much all financial statements will have some form of financial instrument or another in it. Examples of financial instruments include:



FRS 102, para 8.5 requires an entity to disclose its significant accounting policies comprising:

- (a) the measurement basis (bases) used in preparing the financial statements;
- (b) the other accounting policies that are relevant to an understanding of the financial statements.

The FRC's periodic review plans to change the requirement to requiring entities to disclose **material accounting policy information** rather than significant accounting policies. This should provide more clarity as to what does, and what does not, require disclosure in terms of the entity's accounting policies.

Financial instruments

During file reviews, it is not uncommon to notice deficiencies in the accounting policies section of the financial statements. A lot of these deficiencies concern 'boilerplate' disclosures – which is where an accounting policy merely regurgitates the requirements of an accounting standard without any entity-specific tailoring to make the policy concise and appropriate to the entity. Other deficiencies are generally due to over-reliance on accounts production software systems.

All accounting policies should be tailored to be entity specific. Just because an automated accounts production software system may churn out an accounting policy, does not mean that it is right or that it is even appropriate in the entity's circumstances (the policy could be irrelevant or it could relate to an immaterial area of the financial statements).

Many entities will have financial instruments of some guise included in the financial statements.

As noted earlier, these may comprise several different types of financial instrument and therefore it is important to look at the accounting policy in the financial statements to consider its appropriateness.

Consider the following example from a set of financial statements:

Financial instruments

The company recognises a financial instrument when it becomes a party to the financial instrument. A financial instrument is a contract that gives rise to a financial asset of the company or a third party and a financial liability or equity instrument of the company or a third party.

This sort of accounting policy is a 'mishmash' of the definition of a financial instrument from FRS 102. It does not discuss how the entity classifies financial instruments, it does not explain the recognition and measurement policies that have been selected by the entity and it does not talk about derecognition issues.

What would a reasonable disclosure look like?

There is no right or wrong way to disclose accounting policies – but the key is to avoid boilerplate policies and over-reliance on accounts production software generated policies in their entirety.

Keep in mind that financial instruments will still need user-input where accounting policies are concerned because software systems are not that enhanced (as yet) in identifying key aspects of financial instruments (e.g. whether the policy is to recognise at, say, amortised cost or fair value through other comprehensive income).

The example below is taken from a set of financial statements which contains material financial instruments, including debtors and creditors, bank loans and finance leases. It is not meant to be a 'template', but is intended to demonstrate the detail that may be required.

Financial instruments

The company has elected to apply (where applicable) the provisions of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of FRS 102 to all of its financial instruments.

Financial instruments are recognised when the company becomes a party to the contractual provisions of the instrument.

Financial assets are offset, with the net amounts presented in the financial statements, when there is a legally enforceable right to set-off the recognised amounts and there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Basic financial assets

Basic financial assets, which include trade and other debtors, amounts owed by group undertakings and cash and bank balances, are initially measured at transaction price including transaction costs and are subsequently measured at amortised cost using the effective interest rate. The exception to this would be where the arrangement constitutes a financing transaction – in which case, the financial asset is measured at the present value of the future receipts discounted at a market rate of interest.

Impairment of financial assets

Financial assets, other than those held at fair value through profit or loss, are assessed for indicators of impairment at each balance sheet date.

Financial assets are impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows have been affected. If an asset is impaired, the impairment loss is the difference between the carrying amount and the present value of the estimated cash flows discounted at the asset's original effective interest rate. All impairment losses are recognised in profit or loss.

If there is a decrease in the impairment loss arising from an event occurring after the impairment was recognised, the impairment is reversed. The reversal is such that the current carrying amount does not exceed the carrying amount that would have been recognised had the impairment not previously been recognised. Impairment reversals are recognised in profit or loss.

Derecognition of financial assets

Financial assets are derecognised only when:

- the contractual rights to the cash flows from the asset expire or are settled; or
- when the company transfers the financial asset and substantially all the risks and rewards of ownership to another entity; or
- if some significant risks and rewards of ownership are retained but control of the asset has transferred to a third party which is able to sell the asset in its entirety to an unrelated party.

Classification of financial liabilities

Financial liabilities (and equity instruments) are classified depending on the substance of the contractual arrangements entered into.

Basic financial liabilities

Basic financial liabilities, including trade and other creditors, bank loans, finance leases, accruals and amounts owed to group undertakings, are initially recognised at transaction price unless the arrangement constitutes a financing arrangement, where the debt instrument is then measured at the present value of the future payments

discounted at a market rate of interest.

Debt instruments are subsequently measured at amortised cost using the effective interest method.

Derecognition of financial liabilities

Financial liabilities are derecognised when, and only when, the company's contractual obligations are discharged, cancelled or they expire.

Equity instruments

Equity instrument issued by the company are recorded at the fair value of the proceeds received, net of transaction costs. Dividends payable on equity instruments are recognised as liabilities once they are no longer at the discretion of the company.

Remember, the point of accounting policy information is to disclose those significant (i.e. material) policies and to ensure they are as entity specific as possible. This should then result in accounting policy information which is concise, understandable and relevant.

Other disclosure information for financial instruments

In addition to accounting policy information, don't forget that FRS 102, Section 11 requires extensive disclosures to be made in the financial statements relating to financial instruments. A summary of these disclosures is shown in the table below:

Disclosures relating to:	Relevant paragraphs:
Accounting policies for financial instruments	11.40
Statement of financial position – categories of financial assets and financial liabilities	11.41 to 11.44
Derecognition	11.45
Collateral	11.46
Defaults and breaches on loans payable	11.47
Items of income, expense gains or losses	11.48
Financial instruments at fair value through profit or loss	11.48A
Financial institutions and retirement benefit plans	11.48B and 11.48C
Interest rate benchmark reform	11.49 to 11.50

For entities that have financial instruments within the scope of FRS 102, Section 12, the above disclosure requirements must be made. If hedge accounting is being used, the relevant disclosure requirements for such accounting is in paragraphs 12.27 to 12.29A.