BARNES ROFFE

CHARTERED ACCOUNTANTS

TT239 FRS 102 – BASIC FINANCIAL INSTRUMENTS

April 6, 2016

Lending is a very common transaction between entities, it may take the form of a formal bank loan, informal overdraft or a purchase or sale on credit.

The technical part:

The receivable and payable to be recognised by the lender and borrower respectively, are accounted for in accordance with the requirements of Section 11 Basic Financial Instruments or Section 12 Other Financial Instruments of FRS 102.

The standard defines a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument in another.

Financial instruments include both primary financial instruments – financial assets (such as cash, receivables and equity securities of another entity) and financial liabilities (such as debt) – and derivative financial instruments such as financial options, forward contracts, interest rate swaps and future contracts.

This Topical Tip covers the accounting of Basic Financial Instruments that satisfy the following criteria:

- Cash;
- A debt instrument (such as an account, note or loan receivable or payable and is not a derivative as mentioned above);
- A commitment to receive or make a loan to another entity that cannot be settled net in cash;
- An investment in non-convertible preference shares and non-puttable ordinary shares or preference shares (other than investments in subsidiaries, associates and joint ventures). An entity has an investment in non-puttable shares if it does not have an option to sell the shares back to the issuer for cash or another financial asset and there is no arrangement that could result in the shares being redeemed or repurchased by the issuer.

Measurement of basic financial instruments

- An entity shall recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.
- When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price (including transaction costs except where the initial measurement is at fair value through the profit or loss account) unless the arrangement constitutes, in effect, a financing transaction. A financing transaction may take place in connection with the sale of goods or services, for example, if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate.

Practical implications

- **Accounting for financial assets**

For a long-term loan made to another entity, a receivable shall be recognised at the present value of cash receivable (including interest payments and repayment of principal from that entity).

For goods sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that entity, which is normally the invoice price.

For an item sold to a customer on two-year's interest free credit, a receivable should be recognised at the current cash sale price for that item. If the current cash sale price is not known, it may be estimated as the present value of the cash receivable discounted using the prevailing market rate(s) of interest for a similar receivable.

For a cash purchase of another entity's ordinary shares, the investment is recognised at the amount of cash paid to acquire the shares.

- **Accounting for financial liabilities**

For a loan received from a bank, a payable is recognised initially at the present value of cash payable to the bank (e.g. including interest payments and repayment of principal).

For goods purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier, which is normally the invoice price.

Other implications

As you can see the recording of many transactions will remain as before however where an entity has debt instruments or investments there may be some reporting changes required at the end of the reporting period which you need to be aware of. Where an entity has entered into such transactions it needs to measure those financial instruments as follows:

- Debt instruments shall be measured at amortised cost using the effective interest method. Debt instruments that are payable or receivable within one year shall be measured at the undiscounted amount of the cash or other consideration expected to be paid or received (i.e. net of impairment) as is the situation now. If the arrangement constitutes a financing transaction, the entity shall measure the debt instrument at the present value of the future payments discounted at a market rate of interest for a similar debt instrument. It is therefore important for entities to understand the nature of such transactions and also reconfirm whether they are short term or long term in nature, as the accounting treatment will vary depending on the exact circumstances.
- Investments in non-convertible preference shares and non-puttable ordinary or preference shares shall be measured as follows:
- If the shares are publicly traded or their fair value can otherwise be measured reliably, the investment shall be measured at fair value with changes in fair value recognised in profit or loss.
- All other such investments shall be measured at cost less impairment as before.

Conclusion

The requirements under FRS 102 are more comprehensive and require a greater degree of transparency than many entities will have seen under previous standards. Entities will need to consider all the relevant facts and circumstances of a transaction to determine the appropriate accounting treatment. Speak to your Barnes Roffe partner today for a tailored review of how FRS 102 may affect you and how we can help you to manage the consequences of this new standard as applied to your company.