Financial Instrument

IAS 39
Abstract
In 2005 the international accounting IAS / IFRS (International accounting standard/international financial reporting standards) is mandatory for Swedish listed companies. The objective of financial statements is to provide the stakeholders that are outside the company with information that might be useful to see how well a company is. Harmonization of rules makes decision making easier, because also the comparability increases. There is two types of legal system and they are common law and code law. There are many differences between countries behaviour and in reporting and disclosure and the cultural diversity plays a central role with regard to financial statements. IAS 39 is a standard, which provides accounting standards for valuation and accounting of financial assets and liabilities and in some regards the purchase or sale of non-financial items. It plays a big role in determining in which category the instrument must be added in and it is problematic to put the instrument in the right category. The classification of the asset determines the vital measurement method fair value, amortized cost value, historical value. These valuation methods cause unnecessary complexity in financial instrument accounting. The solution of all problems with classification is to use the fair value to measure all financial instruments. This is the area that I am looking at in the analyze.
Introduction
On 1 January 2005, the international accounting IAS / IFRS (International accounting standard/international financial reporting standards) mandatory for Swedish listed companies. The accounting standard is a product from the organisation international accounting standard board (IASB). The objective of financial statements is to provide the stakeholders that are outside the company with information that might be useful to see how well a company is. The groups that the financial information is intended to include lenders, investors, customers, competitors and government, and more. Different users have different objectives and may need different kinds of information, some questions require that you need more and deeper information, while other questions require only superficial information. In a class with Hanno Kirsch\(^1\) he talked about the importance of that financial information should be relevant, the report is to provide stakeholders with what he is seeking, information of a financial nature shall also be easy to understand, in other words, it should be easy for the user to absorb and comprehend. Hanno Kirsch\(^2\) also talked about rehabilitee and comparability and that that it is important for the user to form an opinion on its financial position. The reliability is important to be able to feel that the information is not biased (Alexander et al.2009). There are frequently discussed on today's people about whether the fair value is a dependable method of valuation (Landsman 2007).
Accounting standards setters in many jurisdictions around the world, including the United States, the United Kingdom, Australia, and the European Union, have issued standards requiring recognition of balance sheet amounts at fair value, and changes in their fair values in income. In the US, the FASB (Financial Accounting Standards Board) requires recognition of some derivatives and investment securities at fair value. In calculation, as their accounting rules have evolved, many other balance sheet amounts have been made subject to partial application of fair value rules that depend on different ad hoc circumstances, as well as impairment (e.g., goodwill and loans) and whether a derivative is used to hedge changes in fair value (e.g., inventories, loans, and fixed lease costs). The FASB and the IASB (International Accounting Standards Board) are working jointly on projects examining the feasibility of mandating recognition of basically all financial assets and liabilities at fair value in the financial statements. Estimating fair value for assets and liabilities is quite easy if they are actively traded in liquid markets. The problem becomes more difficult if active markets do not exist (Landsman 2007). Researchers believe that expanded fair-value-based financial statements may supply users useful information, provided the fair value estimates are trustworthy (American Accounting Association’s Financial Accounting Standards Committee2007).

\(^1\) Hanno Kirsch, lesson the 26 august 2009.
\(^2\) Hanno Kirsch, lesson the 26 august 2009.
Harmonization
Different countries have different accounting standards and there is a collaboration working to harmonize them so that comparability should be improved by involving the European Union (EU) and International Accounting Standards Board (IASB). Harmonization means that the countries are trying to get different accounting standards to converge. Some countries have considerable flexibility in accounting rules, and this makes it difficult for shareholders over the world to use financial information in a decision situation. Harmonization of rules makes decision making easier, because also the comparability increases. But even if the harmonization and comparability is introduced, there still differences between nations and these differences play a major role for financial information (Alexander et al.2009). The purpose with harmonization is that all of the world’s entities should have the same opportunity to inspect capital market in the world (Sundgren et al.2007).

Differences in countries
In the lesson with Stefan Olsson he talked about two types of legal system and they are common law and code law. The first one the common law is from the beginning a system that is developed on case law. This law is most legal in commonwealth countries. The common law is based on that it is a legal system that is developed case by case and doesn’t recommend a general rule that can be applied to several cases. In countries where there is common law, accounting regulation is in the professional organisations of the private sector and detailed regulation according accounting is produced by private standard setters. Example on countries that belongs to the common law is United States, Australia, Canada, Ireland and Singapore. The second type of legal system is code law and it was developed in Europe. This legal system is built by a wide set of rules that should guide ones in all situations. The code law is very detailed and standards of accounting are often embodied in the entities law. The accounting regulation is in the hand of the government and financial reporting is in those conditions often reduced to comply with a set of very complete legal rules. Example on countries that belongs to the code law legal system is Scotland, France, Germany, Belgium, Portugal, Spain and Japan. There are many differences between countries behaviour and in reporting and disclosure the cultural diversity plays a central role with regard to financial statements. There is evidence on that national influences affect the quality of financial reporting. (Alexander et al.2009). For example a conclusion of a present study is that the existence of different accounting systems affects the relevance of the accounting information for the companies, it is obvious that there are economy and financial differences between the countries, but these differences are mitigated when we spotlight on listed entities. A number of of the national factors could be better reflected with national standards, probable could it increase the harmonizing consolidated accounting (Arce & Mora 2002).

3 Stefan Olsson, lesson 10 September 2009.
Financial instruments
IAS 39 is a standard, which provides accounting standards for valuation and accounting of financial assets and liabilities and in some regards the purchase or sale of non-financial items. This standard indicates when the financial instruments should be taken up in its balance sheet and how to evaluate them. It also contains information on when they no longer have to account the financial instrument in the balance sheet and how they are classified correctly (Sundgren et al.2007).
Financial instruments can be things as interest rate swaps, treasure bond options, equity swaps, credit swaps, bonds, receivables, loans, and shares for instance. In these days there are even financial instruments that is compounded and that means for example that a debt security can contain both an equity part and a liability part. Over the past 20 years the complexity has financial instrument led to difficulties in recognising, measuring, presenting and disclosure this instruments in financial statements of an entity. The complexity led to those financial instruments where split-up into two groups: first presentation and disclosure and then recognition and measurement. The two first one’s is now IAS 32, Financial instruments: Presentation and IFRS 7, Financial instruments: Disclosures. The second IAS 39 is the subject for complexity caused by that it is very hard in many ways to measure and recognize financial instruments (Alexander et al.2009). To explain the complexity for example a financial instrument that is emitted for example s hares and share options is not treated in the standard whit the explanation that such an instrument is not subject for any change in value. On the other side if the company owns such an instrument that is emitted from other entity’s they have to use the IAS 39 (Sundgren et al.2007). According to a study the difficulty with the present accounting standards is the diversity of methods presented to value financial instruments. The classification of the asset determines the vital measurement method fair value, amortized cost value, historical value. The study suggests that this valuation method causes unnecessary complexity in financial instrument accounting. The study purpose that a solution to the problem with classification is solved is to use the fair value to measure all financial instruments. The arguments for using the fair value in all financial instruments are that it would provide more relevant information for the stakeholder and other users of financial statements. It would also consist with IASB’s long term goals for the measurement fair value. Then the problem with impairment is solved if ones use the fair value because no rule for this is needed. The fair value is a successful measure for assets and liabilities that are held for trading purposes. But the fair value is a very complex measurement (Lane 2008).
The definition of financial instrument

“any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity” (Alexander et al.2009).

IAS 32 and 39 tell about how to identify a financial instrument. The company's aim of holding of the financial instrument plays a big role in determining in which category the instrument must be added in. A financial instrument could be cash, an equity instrument of another entity or a contractual right such as the entity receives cash from other entities financial assets for example different types of receivables. It may also be a contract that allows the company changing financial assets or liabilities with another entity and that this gives a positive result. An example of such an instrument is different types of swaps. It could also be a derivate that will be settled other than a fixed amount of cash of the entity’s own equity instruments.

A financial liability is a contractual obligation provided that it deliver cash or other financial asset to the entity or it could be an exchange financial instrument asset or liability whit other enterprise entity under potentially unfavourable to the entity. It could even be a contract that may be settled in the entity’s own equity instrument if it is a non-derivate for which the entity is obligated to deliver a numbers of the entity’s own equity. In order to know the difference between financial instruments belong to the company's liability or equity, there is some conditions that must be met and they are: Instruments that contractual obligation to deliver cash or other asset/liability to another entity and a instrument which will be settled in the issuers own equity in this case it could be a non-derivate or a derivate (Alexander et al.2009).

Common financial instruments

A share is when you have an ownership interest in a company that provides interference in the company. There are two kinds of shares and they are: Ordinary shares and preference shares. Preference shares, a share in dividends and liquidation have priority over other shares such as ordinary shares. Preference shares provide a better right to the company's assets and / or profits than ordinary shares in bankruptcy or liquidation. A bond is a debt, usually over several years promissory note certifying that the holder has lent money. An option is a contract between a buyer and a seller that gives the buyer the right, but not the obligation, to buy or to sell a particular asset on or before the option's expiration time, at an agreed price. Option is available in two variants call option and put option. Futures contract, in finance, refers to a standardized contract to buy or sell a specified commodity of standardized quality at a certain date in the future, at a market determined price. A swap is a derivative in which two counterparties exchanges certain benefits of one party's financial instrument for those of the other party’s financial instrument. For example two parties could change interest’s payment whit each other from variable to fixed rate (Alexander et al.2009).
Accounting and valuation
In each category there are rules to follow how to evaluate and report the financial instruments. When an asset or liability is accounted for the first time it should be valued to its fair value (Alexander et al. 2009). In other word, assets and liabilities should be accounted by the value you purchased the asset for (the historical value) or the fair value in the balance sheet. But there is another way to do it also and that is to record the profit and loss for the instrument directly or to account it separately in component of equity. If one chose to do it as it is explained lately it will not affect profit and loss until the result is realized. As long as the entity owns the financial asset or financial liability ones have to value the instrument when it is time for final account, the change of value should be accounted after each category rule, that is, out to profit or loss or directly to the balance sheet. Following years when the entity do there final account ones have to valuate there financial assets and liabilities in three ways: Fair value, amortized cost value and historical value (Alexander et al. 2009).

The definition of fair value according to Dominique Rachez 4 is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an "arm's length transaction. The general rule is to valuate to fair value but there are some except. Loan receivables and investments to be held to maturity are valued as amortized cost and investment in equity instrument where its price is difficult to examine is valued to its purchase prise (historical price). In the end when the asset or liability exists no longer you take it away from the balance sheet. If the entity wants to remove the asset or liability away from the balance sheet there are some things ones have to consider. The assets cash flow has to be ceased and the entity have for example sold the asset or liability (Alexander et al. 2009). To report assets at fair value and liabilities at amortized cost distort seriously the performance during changes in interest rates and therefore interest rate risk is measured incorrectly. Currently, IAS 39 requires that assets are valued at fair value except held to maturity securities and loans and securities not held for trading, while financial liabilities, excluding derivatives, are measured at amortized cost. It could lead to misleading financial statements if liabilities are measured at amortized cost and assets at fair value (Gray 2003).

Categorises of financial assets
In IAS 39 there are four categories of financial assets and they are:

Financial assets that are
- held for trading
- loans and receivables
- held to maturity investment
- available to sale (Alexander et al. 2009).

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4 Dominique Rachez, lesson the 16 september 2009.
According to Dominique Rachez\textsuperscript{5} is a financial asset who is held for trading defined as that it is an acquired asset that was bought with the intention that it should be held for short time and be sold and generate current profit. If the asset will be accounted directly with fair value over the profit and loss statement there is two things that have to be fulfilled. First the instrument have to be held for trading and two it have at the first accounting moment be valued to fair value thru the profit and loss statement (Sundgren et al.2007). Investments that is held to maturity is financial assets that all as often has a fixed maturity an example on this is an investment in bonds that the entity is keeping no matter what the bond develop. If the company has placed there financial instrument in this category it means that they can not plan to sell it. In the category loan and receivables financial assets that aren’t published on an active market and who has a determined cash flows included. An asset that belongs in this category doesn’t need to be held to maturity it is ok to for example see Invoices to other companies before they due. The last category is available to sale and that category contains the financial instruments that doesn’t fit in no other category. Some liability instrument and equity instrument could fit in this category. This shows the complexity to qualify financial instrument in the right category. The entity have a big freedom to choose witch category they will put there financial instrument in but for last it is the auditor who should approve and sign the report (Sundgren et al.2007).

**Fair value**

Of these four assets there are two that should be valued to fair value and accounted directly to the balance sheet and they are assets that are accounted directly to profit and loss and financial assets that are held for trading. These two is investment in liability instrument as bonds and is not held to maturity. That profit or losses that are gained do to change in fair value should not affect the profit and loss, the change should be accounted directly to the equity if the financial instrument belongs to the category financial asset that is held for trading. Only profit or loss that is realized should be accounted directly to profit and loss. If profit or loss is gained from an financial instrument and the change in value is on an asset that belongs to the category assets that is valued to fair value and is accounted directly to profit and loss should be accounted directly to profit and loss. This entire means that even an unrealized profit affect the profit and loss statement if the asset is in the category of financial instrument that is valued to fair value directly thru profit and loss. This is under the condition that the financial asset isn’t a part of a security and thereby is a part of the entity’s strategy for risk management (Sundgren et al.2007).

\textsuperscript{5} Dominique Rachez, lesson the 16 september 2009.
**Historical value**
The historical value is that value that is used less frequently and it is that value that the entity paid for the asset. This principle is only used for investment in unlisted equity instrument; it can also be used for equity instrument that is not listed on a market. It is very hard to estimate the fair value on these assets therefore is the historical value used for this category. A financial asset that is valued by the historical value are not revaluated, if the asset have lost some value ones have to impair the asset (Sundgren et al. 2007).

**Amortized cost value**
To reach the amortized cost value you should use the effective annual percent of rate (EAR) method. The EAR is the rate that discounts the future interest cost and amortization to net asset value. The discounting of the asset is something that happens during the assets whole expected maturity. There is to financial assets who should be valued by this method and they are investments held to maturity and loans and receivables. One example on a financial asset that is held to maturity is bonds; this instrument will give the entity interest income. This income should be accounted in the income statement profit/loss as an income of rate. The profit will not be accounted before it is realized. It is when ones have sold the financial instrument ones can account the gained profit to the income statement. And if there is impairment they should be impaired as a cost in the income statement. The assets value on the balance sheet will change over time even if a real change in value not has happened (Sundgren et al. 2007).

**Impairment**
Financial assets that are accounted directly to profit and loss and valued to their fair value is not an object for impairment. A financial asset who is valued to their fair value can not be impaired because all changes in value is accounted directly in the income statement profit and loss. An impairment test decide if their has been some change in value on the day of the final balance sheet. The impairment is the difference between the book value of the asset and the present value of the future cash flow for the object. The impairment amount should be accounted as a cost in the income statement profit and loss (Sundgren et al. 2007).

**Categories of liabilities**
In IAS 39 there are two categories of financial liabilities and they are:

- Financial liabilities valued by fair value through profit or loss
- All financial liabilities that isn’t in the category above.

According to Dominique Rachez ⁶ the first category there is financial instrument that is held for trading and the purpose of them is to generate profit. In the second

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⁶ Dominique Rachez, lesson the 16 september 2009.
category can the entity's financial liabilities like bank loan and other types of loan be placed. That's the category where you can find the largest part of the companies’ liabilities. Under IAS39, it is difficult or extremely limited to change category for the company’s financial instruments. In IAS 39 it is not allowed to change category from financial assets and liabilities that are valued to fair value through profit or loss while they are held or are outstanding. Nor is it acceptable to change the category of loan receivables and accounts receivable to assets held for sale (Sundgren et al. 2007).

**Analys**

After familiarize myself with the substance on the financial instruments and how these reports you realize suddenly that the subject is very complex and many mistakes in evaluation and error can occur. The global market increase and the capital market is also increasing when Swedish companies buy entities in other countries. The globalisation is god for companies but it also increases the risk for a company. A way to protect ones is to use a financial instrument, but the instrument is not just for risk handling it is also used for investments and speculations. A financial statement is developed to explain how well a firm is, but with fair value, there are different opinions about whether it is reliable or not. Since the real value is difficult to determine when it's up and downs in the economy it might be more reliable to use the historical value in the accounting and if ones use this value ones is more careful and have not over valued an asset. If an active market is missing or fair value is difficult to determine the entity have to use of other methods to develop the fair value. One can assume that these valuation methods are developed out of the company's management and this can mislead the value and the assumption is made on the wrong grounds. That management may choose to withhold information which can make the valuation subjective. If the information should be of interest for stockholders it should be trustworthy, this is hard to achieve because the fair value varies across time and the world economy fluctuate. The research for this topic shows that the fair value is preferable as it would make it easier for stakeholders to compare when they are using financial statements for taking decisions. The use of fair value should also facilitate the impairment as such will not be useful because no impairment have to be done on financial assets that are valued to fair value. It is of great importance that a financial instrument is placed in the right category because when it comes to accounting there are different rules if the value has to be placed in the profit and loss or directly in the balance sheet. It is also of great importance that the instrument is placed in right category because there is very hard to change category. The complexity that govern how to recognize and categorize financial instruments is very easy to mistake and error and it is easy to place ones assets and liabilities wrong. This is of great value for the reliability and comparability in the financial report. That there are differences between countries, how ones look at accountability and the different rules that exist and that this affects rehabilitee in a financial report is a fact thru studies in the subject. A present study shows that the existence of different accounting systems affects the relevance of the accounting information for the companies.
Conclusion
The only conclusion of this is that many things around effect a financial report and it is of importance. A harmonization of methods for accounting and valuation should increase the reliability in financial reports. To put financial instrument in right categorise is in deed a hard thing to do in these days but it is also very important to do things right to give the readers of financial reports a fair picture. If a financial instrument should be valued and recorded in the most reliable manner possible there have to be a simpler way to do things. Rules for accounting a financial instrument must be simpler and less complicated. For example, to evaluate all financial instruments to fair value might be a solution because if there is only one method it will enhance the comparability in the financial report for stockholders and make it easier for them to decide and compare. It will also make it easier because there will be no impairment because of the use of fair value.


