
Professional Certificate in International Accounting Standards for Financial Instruments

Financial Instruments: Measurement and Recognition

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Financial instruments are contracts that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Measurement and recognition of financial instruments are crucial aspects of accounting standards to ensure transparency and accuracy in financial reporting. International Accounting Standards (IAS) provide guidelines for the measurement and recognition of financial instruments to enable consistent and reliable reporting across different entities and jurisdictions.

Amortized Cost

Amortized cost is the amount at which a financial instrument is measured on initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount.

Related Terms: Effective Interest Method, Initial Recognition

Example: A company purchases a bond at a discount of \$95,000 with a face value of \$100,000. The amortized cost of the bond after one year would be \$96,000 (\$95,000 + \$1,000 amortization).

Available-for-Sale Financial Assets

Available-for-sale financial assets are non-derivative financial assets that are designated as available for sale or that are not classified as loans and receivables, held-to-maturity investments, or financial assets at fair value through profit or loss. They are measured at fair value with changes in fair value recognized in other comprehensive income.

Related Terms: Fair Value, Financial Assets

Example: Stocks and bonds held for investment purposes are examples of available-for-sale financial assets.

Derivative Financial Instruments

Derivative financial instruments are financial contracts whose value is derived from the value of an underlying asset, index, or rate. They include options, futures, forwards, and swaps. Derivatives are measured at fair value with changes in fair value recognized in profit or loss.

Related Terms: Fair Value, Underlying Asset

Example: An option to purchase a stock at a predetermined price is an example of a derivative financial

instrument.

Effective Interest Method

The effective interest method is a method of calculating the amortized cost of a financial asset or liability and of allocating interest income or expense over the relevant period. It is used to calculate interest revenue or expense and to adjust the carrying amount of a financial instrument.

Related Terms: Amortized Cost, Interest Income

Example: Using the effective interest method, a company calculates the interest revenue on a bond investment by applying the effective interest rate to the carrying amount of the bond.

Fair Value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Financial instruments are measured at fair value, with changes in fair value recognized in profit or loss or other comprehensive income.

Related Terms: Market Participants, Measurement Date

Example: The fair value of a stock is the price at which the stock could be sold in an open market transaction between willing buyers and sellers.

Financial Assets

Financial assets are assets that are cash, evidence of an ownership interest in an entity, or a contract that conveys a right to receive cash or another financial asset from another entity. They include cash, equity instruments, debt instruments, and derivative financial instruments.

Related Terms: Equity Instruments, Debt Instruments

Example: Stocks, bonds, and loans receivable are examples of financial assets.

Financial Liabilities

Financial liabilities are obligations to transfer cash or another financial asset to another entity. They include payables, loans, and bonds issued by an entity. Financial liabilities are measured at amortized cost or fair value.

Related Terms: Amortized Cost, Fair Value

Example: Accounts payable, bank loans, and bonds payable are examples of financial liabilities.

Financial Instruments at Fair Value through Profit or Loss

Financial instruments at fair value through profit or loss are financial assets or liabilities that are designated as such on initial recognition or that are classified as held for trading. They are measured at fair value, with

changes in fair value recognized in profit or loss.

Related Terms: Fair Value, Held for Trading

Example: A derivative contract held for speculative purposes is classified as a financial instrument at fair value through profit or loss.

Financial Instruments: Measurement and Recognition: Challenges

The measurement and recognition of financial instruments present several challenges for entities, including determining the appropriate classification of financial instruments, calculating fair values, and applying complex accounting standards. Entities must also consider the impact of changes in fair value on their financial statements and the potential for volatility in reported results.

Challenges:

1. **Classification:** Entities must carefully evaluate the characteristics of financial instruments to determine their appropriate classification as financial assets or liabilities and their subsequent measurement basis.
2. **Fair Value Measurement:** Calculating fair values for financial instruments can be complex, especially for illiquid or non-traded instruments. Entities must use judgment and market data to estimate fair values accurately.
3. **Accounting Standards:** The accounting standards for financial instruments are detailed and require entities to apply complex measurement and recognition criteria. Compliance with these standards can be challenging for entities with limited resources or expertise.
4. **Volatility:** Changes in fair value can result in volatility in reported financial results, especially for financial instruments measured at fair value through profit or loss. Entities must consider the impact of this volatility on their financial statements and communicate effectively with stakeholders.

Held-to-Maturity Investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intent and ability to hold to maturity. They are measured at amortized cost and do not include equity instruments.

Related Terms: Amortized Cost, Financial Assets

Example: Bonds held by a company with the intention of holding them until maturity are classified as held-to-maturity investments.

Initial Recognition

Initial recognition is the process of recognizing a financial instrument on an entity's balance sheet when the entity first becomes a party to the contractual provisions of the instrument. It involves measuring the financial instrument at its fair value and determining its subsequent classification and measurement basis.

Related Terms: Fair Value, Classification

Example: When a company issues bonds to raise capital, the bonds are initially recognized on the balance sheet at their fair value.

Interest Income

Interest income is the revenue earned by an entity on its interest-bearing financial assets, such as loans, bonds, and deposits. It is calculated using the effective interest method and recognized in the income statement over the relevant period.

Related Terms: Effective Interest Method, Financial Assets

Example: A bank earns interest income on its loans by charging borrowers a specified interest rate on the outstanding loan balance.

Loans and Receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are measured at amortized cost using the effective interest method and include loans, trade receivables, and other debt instruments.

Related Terms: Amortized Cost, Financial Assets

Example: A company's trade receivables from customers for goods sold on credit are classified as loans and receivables.

Market Participants

Market participants are buyers and sellers in the principal or most advantageous market for the asset or liability. Fair value measurement considers the perspective of market participants who are knowledgeable, willing, and able to transact in the market for the asset or liability.

Related Terms: Fair Value, Fair Value Measurement

Example: Market participants in the stock market include individual investors, institutional investors, and market makers who buy and sell stocks.

Measurement Date

The measurement date is the date at which the fair value of a financial instrument is determined for financial reporting purposes. It is the point in time at which the asset or liability is valued based on market conditions and observable data.

Related Terms: Fair Value, Financial Reporting

Example: The measurement date for a bond investment is the end of the reporting period when the fair

value of the bond is determined for inclusion in the financial statements.

Other Comprehensive Income

Other comprehensive income is the component of comprehensive income that includes items of income and expense that are not recognized in profit or loss. Changes in the fair value of available-for-sale financial assets and foreign currency translation adjustments are examples of items included in other comprehensive income.

Related Terms: Comprehensive Income, Fair Value

Example: Unrealized gains and losses on investments classified as available-for-sale are recorded in other comprehensive income until the investments are sold.

Professional Certificate in International Accounting Standards for Financial Instruments

The Professional Certificate in International Accounting Standards for Financial Instruments is a specialized certification program that provides in-depth knowledge and practical skills in applying international accounting standards to financial instruments. The program covers key concepts, principles, and requirements related to the measurement and recognition of financial instruments in accordance with International Financial Reporting Standards (IFRS).

Related Terms: International Accounting Standards, Financial Instruments

Example: A finance professional completes the Professional Certificate in International Accounting Standards for Financial Instruments to enhance their expertise in accounting for complex financial instruments.

Recognition

Recognition is the process of including a financial instrument on an entity's balance sheet and income statement. It involves identifying and measuring the financial instrument, determining its classification, and recording the relevant amounts in the financial statements.

Related Terms: Balance Sheet, Income Statement

Example: When a company borrows funds from a bank, the loan is recognized on the balance sheet as a financial liability and the interest expense is recognized in the income statement.

Risk Management

Risk management is the process of identifying, assessing, and mitigating risks associated with financial instruments to achieve the entity's objectives. It involves implementing strategies to manage credit risk, market risk, liquidity risk, and other risks that may impact financial performance.

Related Terms: Credit Risk, Market Risk

Example: A company hedges its foreign currency exposure using derivative financial instruments to reduce the risk of adverse exchange rate fluctuations.

Subsequent Measurement

Subsequent measurement is the process of determining the carrying amount of a financial instrument after initial recognition. It involves applying the appropriate measurement basis, such as amortized cost or fair value, and adjusting the carrying amount based on changes in fair value or other factors.

Related Terms: Initial Recognition, Carrying Amount

Example: A company revalues its investment in equity securities at fair value at the end of each reporting period for subsequent measurement.

Transfers of Financial Assets

Transfers of financial assets are transactions in which an entity transfers a financial asset to another party, either by sale or by entering into a repurchase agreement or a securitization transaction. The accounting treatment of transfers of financial assets depends on the nature of the transfer and the retention of risks and rewards.

Related Terms: Repurchase Agreement, Securitization

Example: A bank sells a portfolio of mortgage loans to a special purpose entity in a securitization transaction, transferring the credit risk associated with the loans.

Valuation Techniques

Valuation techniques are methods used to estimate the fair value of financial instruments that are not traded in an active market. They include discounted cash flow analysis, option pricing models, and comparable transactions analysis. Valuation techniques require judgment and expertise to determine fair values accurately.

Related Terms: Fair Value, Discounted Cash Flow

Example: An appraiser uses valuation techniques to determine the fair value of an unlisted company's shares for financial reporting purposes.

Write-Downs and Impairments

Write-downs and impairments are reductions in the carrying amount of financial assets to reflect a decline in their recoverable amount or fair value. Write-downs are recognized in profit or loss, while impairments are recognized as a separate line item in the income statement.

Related Terms: Carrying Amount, Recoverable Amount

Example: A company writes down the value of its accounts receivable to reflect the expected loss on

uncollectible receivables due to a customer's bankruptcy.