Hong Kong Financial Reporting Standards: HKAS 32

(relevant to PBE Paper I – Financial Reporting)

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HKAS 32 "Financial Instruments: Disclosure and Presentation"

This article provides an overall explanation of requirements of HKAS 32. It includes a definition of "financial instruments" and some key presentation issues.

Definition

According to HKAS 32, a financial instrument is any contract that gives rise to a financial asset for one entity and a financial liability or equity instrument of another entity. In this definition, "contract" refers to an agreement between two parties under which the parties have the obligation to perform their duties because the agreement is usually enforced by law.

The term "financial instrument" includes three key elements:

a. Financial asset: this includes any assets that give rise to a contractual right to receive cash or other financial assets e.g. trade receivables, investment in shares, loans receivable.

b. Financial liability: this includes any contractual liability to pay cash or other financial assets e.g. bank overdrafts, trade payables, loans payable.

c. Equity instrument: this includes any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Examples include ordinary shares or share options.

The following diagrams show some examples of financial instruments:

1. ABC Ltd deposits $1,000 cash in Hang Seng Bank.

In books of ABC Ltd		**In books of Hang Seng**
Cash at bank	Deposit $1,000 cash in → Hang Seng Bank	Amount due to ABC Ltd
Financial assets		Financial liabilities

Cash deposited in a bank is a financial instrument. If ABC Ltd deposits cash in a bank, it is a financial asset of ABC Ltd and a financial liability of the bank, because the bank has a contractual obligation to repay the cash to ABC Limited.

2. ABC Ltd sells goods for $1,000 to XYZ Ltd on credit.

In books of ABC Ltd		**In books of XYZ Ltd**
Trade receivables	Sell $1,000 goods → on credit	Trade payables
Financial assets		Financial liabilities

This is a financial instrument since the sale of goods creates an agreement between ABC Ltd and XYZ Ltd. In such an agreement, the trade receivable is a financial asset of ABC Ltd because it gives the company the right to receive cash from XYZ Ltd, while the trade payable is a financial liability of XYZ Ltd since it creates an obligation for the company to pay cash to ABC Ltd.

3. ABC Ltd purchases $1,000 bonds in XYZ Ltd

In books of ABC Ltd		**In books of XYZ Ltd**
Bonds receivable	Purchase $1,000 bonds →	Bonds payable
Financial assets		Financial liabilities

A purchase of bonds is a financial instrument since it creates a contractual agreement between ABC Ltd and XYZ Ltd. ABC Ltd considers the investment in bonds as a financial asset and has the right to receive interest while XYZ Ltd regards the bonds payable as a financial liability and has the obligation to pay interest.

4. ABC Ltd purchases 1,000 shares in Hang Seng Bank.

In books of ABC Ltd		**In books of Hang Seng**
Equity investment	Purchase $1,000 bonds →	Ordinary shares
Financial assets		Equity instrument

This is also a financial instrument since the investment in shares creates a contract between ABC Ltd and Hang Seng Bank. ABC Ltd considers the investment in shares as a financial asset and has the right to receive dividends while Hang Seng Bank regards the ordinary shares as an equity instrument and has the obligation to pay dividends.

In summary, a financial instrument has the following characteristics:

a. It is a contractual agreement between two parties.

b. It involves one party's contractual right to receive which is matched by the other party's corresponding obligation to pay.

c. It must be settled in the future.

The application guidance of HKAS 32 also states that the following assets and liabilities are not financial instruments because they do not meet the definition of financial instruments:

Tangible and intangible assets	Tangible and intangible assets (such as property, plant and equipment, patent and trademarks) are not financial assets since they only generate an inflow of cash but do not give rise to a present right to receive cash or other financial assets.
Prepaid expenses	Such assets are associated with the receipt of goods or services, rather than the right to receive cash or other financial assets.
Deferred revenue	Such liabilities are associated with the future delivery of goods or services. They do not give rise to a contractual obligation to pay cash or any other financial asset.
Warranty obligations	Such items are not financial liabilities and they are associated with the future delivery of goods or services but do not give rise to a contractual obligation to pay cash or another financial assets.
Income tax assets or liabilities	Such items are not contractual but are imposed by statutory requirements.
Constructive obligation	Such items do not arise from contracts and are not financial liabilities.

Example 1

Identify which of the following are financial instruments:

a. Purchase 15 percent voting ordinary shares
b. Purchase 25 percent voting ordinary shares
c. A liability for profits tax
d. Prepayments for goods or services
e. Issued debt instruments
f. Inform employee and make a promise to raise salary

a. An investment in 15 percent of a company's equity is a financial instrument. This is a financial asset because the investor has the right to receive dividends from the issuer of the ordinary shares.
b. A purchase of 25 percent of voting ordinary shares is also a financial instrument. However, holding 25 percent of the shares in a company implies that the investor has significant influence over the investee. Such an investment is generally outside the scope of HKAS 32 and is accounted for as an investment in an associate instead.
c. Profits tax liability is not a financial liability because it does not arise from contractual rights or obligations, but from statutory requirements.
d. Prepayments for goods or services are not financial assets because they are associated with the receipt of goods or services. They do not give rise to a present right to receive cash or any other financial asset.
e. Issued debt instruments meet the definition of a financial liability because the issuer has to pay regular interest and the principal on maturity.
f. This is a constructive obligation which does not arise from contracts and is not a financial liability.

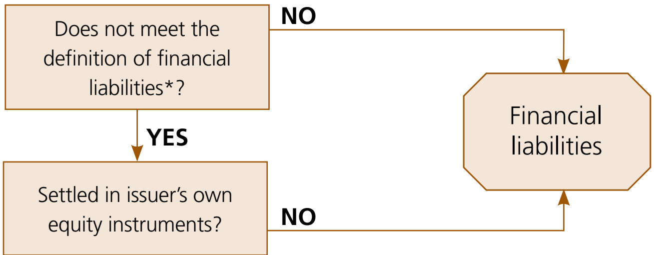
Presentation issues

The standard has some rules for the presentation of financial instruments:

1. Classification as **liabilities** or **equity**

HKAS 32 indicates that when identifying a financial instrument as debt or equity, classification should be based on the substance of the contractual agreement rather than legal form. For example, the issue of ordinary shares that are redeemable at the option of the holder is equity in legal form, but in substance it meets the definition of a financial liability.

A critical principle that should be used to differentiate a financial liability from an equity instrument is the existence of a contractual obligation that meets the definition of a financial liability. For example, the owner of an equity instrument is entitled to receive dividends, but the company does not have a contractual obligation to make the payment. Therefore, HKAS 32 provides the two specific conditions below must be met in order to classify a contract as an equity instrument:



* Definition of financial liabilities: Contractual obligation to deliver cash or other financial asset to another entity on potentially unfavourable terms.

Example 2

Suppose ABC Limited has the following financial instruments:

1. A cumulative and redeemable preference share
2. An issued share option
3. A 10 percent perpetual bond
4. A forward contract to repurchase a fixed number of its own shares for a fixed amount of cash

Discuss and classify the above financial instruments as financial liabilities or equity in accordance with HKAS 32.

1. A cumulative and redeemable preference share is a financial liability since ABC Limited has an obligation to pay cumulative dividends and to repay the amount to the holder when it is redeemed.
2. An issued share option is an equity instrument since this is a contract under which ABC Limited should deliver a fixed number of its own shares for settlement.
3. A 10 percent perpetual bond that pays 10 percent interest each year should be classified as a financial liability. Such an instrument contains an obligation to pay interest and it meets the definition of a financial liability.
4. A forward contract is a financial liability since ABC Limited has an obligation to pay a fixed amount of cash to repurchase a fixed amount of its own shares. This meets the definition of a financial liability.

2. Compound financial instruments

Compound financial instruments are financial instruments which contain both a liability and an equity component. For example, a convertible bond is a compound financial instrument because it contains an obligation to pay interest and principal payment and grants an option to the holder to convert it into a fixed number of ordinary shares. HKAS 32 requires such components to be presented separately using split accounting. The following table shows how split accounting should be used to separate the liability and equity components of compound financial instruments.

Item	Measurement basis
Convertible bonds	Use proceeds received in issuing the convertible bonds (A)
Liability component of convertible bonds	Use the fair value of similar bonds or present value of future cash flow from convertible bonds (B)
Equity component of convertible bonds	A – B

Example 3

ABC Limited issues 5 percent convertible bonds with a nominal value of $90,000 at $100,000 at the start of year one. The bonds have a three-year term and the interest is payable at end of each year. The interest rate for a similar bond without any equity component is 10 percent.

The liability component is the fair value of a similar financial liability without an equity component, which is determined as follows:

	$
Present value of the principal $90,000/(1+10\%)^3$	67,618
Present value of the interest $4,500/(1+10\%)+4,500/(1+10\%)^2+4,500/(1+10\%)^3$	11,191
Total liability component	78,809
Equity component (balancing figure)	21,191
Fair value of convertible bonds	100,000

The journal entry for year one is:

	Dr $	Cr $
Bank	100,000	
Bond payable		78,809
Equity		21,191

3. Treasury shares（庫存股票）

If an entity's own equity instruments are reacquired by the entity or by other members of the consolidated group, they are treasury shares. According to HKAS 32, treasury shares should not be classified as financial assets regardless of the reason for which they are reacquired. Instead, they should be presented as deductions from shareholders' equity in the balance sheet.

Example 4

ABC Limited issues 1,000 shares of $1 each at $1.1 at the start of year one. At the end of year one, the company reacquired 400 of its shares for $1.2. The company has a retained profit of $700 at the end of year one.

According to HKAS 32, the treasury shares are not financial assets. Therefore, the journal entry at end of year one is:

	Dr $	Cr $
Treasury shares 400 x $1.2	480	
Bank		480

Extract from balance sheet showing the balance of shareholders' equity as at the end of year one:

	$
Share capital	1,000
Share premium 1,000 x $0.1	100
Retained profits	700
Treasury shares	(480)
Total shareholders' equity	1,320

HKAS 32 further provides that no gain or loss should be recognized in the profit and loss account on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration received or paid arising from repurchases or sale of treasury shares should be recognized directly in equity.

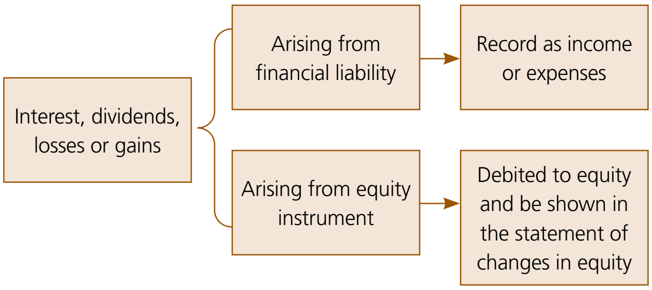
4. Presentation of interest, dividends, losses or gains

The classification of a financial instrument as a liability or equity determines whether interest, dividends, losses and gains relating to that instrument are recognized in income statement or directly in equity.

a. Interest, dividends, losses or gains arises from a financial liability should be recorded as income or expenses in the income statement. For example, dividends payable to the holders of redeemable and cumulative preference shares are recognized in the income statement as an item of expense since the redeemable preference shares are financial liabilities.

b. Interest, dividends, losses or gains arising from an equity instrument should be recorded in equity. For example, gains or losses on the fair value of equity instruments of the entity are recorded in equity.

The following diagram summarizes the above accounting treatment for presentation of interest, dividends, losses or gains:



5. Offsetting of financial assets and liabilities

The general rule is that financial assets and financial liabilities should not be offset in the balance sheet. However, HKAS 32 allows financial assets and financial liabilities to be offset and the net amount presented in the balance sheet when both the following conditions are met:

a. the entity currently has a legally enforceable **right** to set off the recognized amounts; and

b. the entity **intends** either to settle on a net basis, or to realize the assets and settle the liabilities simultaneously.

For example, if ABC Limited sells to and buys from XYZ Limited and both parties agree to settle on a net basis at end of each month, the amount due to and the amount due from XYZ Limited should be offset and net amount presented on the balance sheet of ABC Limited.

Offsetting does not mean derecognition. In other words, both financial assets and financial liabilities are still recorded in the appropriate accounts in the books of the entity. But for balance sheet presentation, they are netted off and presented as a single item.