

Conceptual Approaches in Financial Instruments Sphere

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Abstract

The article examines the conceptual approaches in the sphere of financial instruments according to international regulations. The article analyzes the conceptual boundaries of financial instruments, their classification into financial asset, financial liability and equity instrument. An explicit illustration of how to recognize the financial asset and financial liability provides financial statement users more opportunities on how to understand the concept of financial instrument. The conclusion is that with the complex confrontation of financial instruments, a more accurate and clear accounting is needed in order to exclude the mystery which surrounds them.

Key words: financial instruments, financial asset, financial liability, equity instrument.

J.E.L. classification: G23

Introduction

Each page readed in addition, every idea, every analysis and a lot of questions that continually arise in attempt to study one analyzed aspect, remind us the words of Thomas Carlyle , who said: «go to where the eye can see, and when you get there you'll be able to see further."

Appears a belief that this is a common feeling for any researcher who wants to carry out a study, which could be small but thoroughly developed, but it is impossible not to highlight the variety of issues raised by a subject such as accounting for financial instruments. To get to the essence of the accounting there is a need for conceptual delimitation of what will be examined, appropriate induction of financial instruments in their environment, namely capital markets and then we can talk about accounting treatments (Epstein B.J., Nach R., Bragg S.M., 2008, p.86).

When financial statements are mentioned, the rules play an important role in ensuring clarity and comparability of the information provided, yet the reality is that some rules within current standards arose precisely in the absence of principles or being guided by some inadequate principles. Identifying principles of accounting for financial instruments is not at all an easy task, the economic essence is often difficult to extract from ideological sails that developed financial experts in finance. Moreover, there are opinions that when financial instruments are mentioned there are part of principles-based system, even in the case of referential international accounting.

As a result appears a difficult task that requires the widest possible disclosure of the issues related to financial instruments, particularly derivatives, in order to ensure their right to a fair analysis.

Unlike disciplines that are subject of natural laws, accounting is a tool of human behavior, being constructed and used by individuals for specific purposes. It is also extremely important to recognize that accounting theory is closely related to the accounting practice; unrealistic theories have no life.

The main purpose of accounting theory is to explain the current accounting practices and to provide the necessary basis for further development of these practices. Accounting Theories presents a concept moderm that should be compared with other areas such as physics and mathematics; accountancy developing through a set of tools by recording the activity or transaction.

Conceptual delimitations of financial instruments

Addressing key elements in terms of financial instruments accounting, identify the manner in which elements belong to different theories and research that can be merged into the main categories of studies conducted on the capital markets. Purpose of these correlations, is to define the main lines of analysis and identification of a general theory corresponding to the complex nature of the topic addressed, requiring a study case in the same generalist spirit.

It would be better to address primarily conceptual boundaries of financial instruments serving purpose of accounting, detailing the issue of financial instruments classification in the category of financial assets, financial liabilities and equity instruments respectively. It welcomes the illustration of the complex diversity of financial instruments to be classified in the categories mentioned (KPMG, 2008, p.167).

Principles that guide the entities now in their classification and delimitation from the perspective of the issuer, are set out in International Accounting Standard 32 Financial Instruments: presentation. According to IAS 32, the instrument represents a contract that generates a financial assets for one entity and a financial liability or an equity instrument for another entity (IASB, 2009, p. 1418).

There should be an achievement from this point of distinction between so-called real assets (non-financial) and financial assets, first making reference to those assets that have intrinsic value, because of their utility (tangible and intangible), while in the end it represents rights on real assets. By default, financial liabilities are considered counterparty of financial assets. Thus expanding the definition of financial instrument, are included in this category and those buy or sell contracts of a non-financial item that can be settled net in cash or another financial instrument, by exchanging financial instruments, except for contracts initiated and maintained with the purpose of receiving or delivery of a non-financial item in accordance with the requirements of purchase, sale or usage expected of the entity (IASB, 2009, p. 1417). Many commodity contracts are standardized and traded on organized markets as derivative financial instruments, which can be easily sold or bought for cash, because of the listing for trade on the stock exchange and thus changing hands many times. However, the parties buying and selling the contract trade in reality with basic commodities.

The ability to buy or sell a commodity contract for cash, the ease of conducting these transactions and the possibility of negotiating a settlement with cash obligation to deliver the goods or the right to receive it, does not alter the fundamental character of the contract in a manner that would create a financial instrument. There is however the possibility that some contracts to buy or sell non-financial items to materialize in financial instruments, when they can be settled net or by exchanging financial instruments, or the non-financial item is readily convertible to cash. There is also possibility that some contracts refer to the goods without involving settlement by physical delivery or receipt of goods, specifying settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts.

A clear understanding of the definitions of IAS 32 and IAS 39 is necessary not only to achieve an adequate conceptual delimitations of financial instruments, but also their practical applicability as practitioners in most cases make reference to definitions. The commitment of these causes clear economic consequences, with no or little possibility to be avoided, usually due to the execution power of the undertaking. Contrary to the contract that tend to appeal to its connotations as a legal instrument must consider the issue of nature and not the legal aspect, to determine whether there is a contract or contractual obligation.

Classification of Financial Instruments

Financial instruments include both: primary instruments, such as receivables, payables and equity instruments, and derivatives such as futures, forwards and financial options.

International Accounting Standard 39 Financial Instruments: Recognition and Measurement defines them as non-derivative financial instruments and derivatives (Duțescu A., 2004, p.43). IAS 39 also stipulates in classifying derivative financial instruments as it needs to meet all of the following three characteristics:

1. Value, that changes in response to certain interest rate, financial instrument price, commodity price, foreign exchange rates, price indices, credit rating or credit index, or other variable, with the condition that, in case of nonfinancial variable, should not be specific to a party of the contract;

2. Does not require an initial net investment or require an initial net investment that is smaller than those required for other types of contracts that are expected to have a similar response to changes in market factors, and

3. it is settled at a future date (Epstein B.J., Nach R., Bragg S.M., 2008, p.239).

The users of the information provided of financial statements consider extremely important to establish the distinction between financial liabilities and equity instruments. The most important reasons being concerns about the solvency of the entity, diluting the interest of owner equity of the entity's obligations may require the use of cash or other assets, priority of the rights over the assets of the entity or the identification of those instruments which generate owner interest in equity an entity's own. In this context, I mention the difficult task present for professional bodies to develop as soon as possible a model that will allow simple and clear demarcation of financial liabilities and equity instruments, being applicable also for most complex financial instruments.

Specific approach for the term of financial asset

Given the definition content through financial asset can mean any asset that is:

1. Cash

2. An equity instrument of another entity

3. A contractual right

a) to receive cash or another financial asset from another entity, or

b) to exchange financial assets or financial liabilities with another entity under potentially favorable to the entity conditions, or

4. A contract that will or may be settled in own equity instruments of the entity (IASB, 2009, p.1418). It envisages a non-derivative that require or may require the entity receiving a variable number of its own equity instruments or a derivative that will or may be settled other than by a fixed amount of cash or another financial asset for a fixed number of equity instruments of the entity. It therefore argues that an entity's own equity instruments do not include instruments that are themselves contracts for receiving or delivering its own equity instruments of the entity (IASB, 2009, p.1419).

Examples of financial assets may be:

- cash (currency)

- effects receivable,

- accounts receivable,

- loans receivable,

- bonds receivable etc.

Accrued expenses are not financial assets by virtue of the fact that definition is not met, the future economic benefits associated with reference to the receipt of goods or services rather than the right to receive cash or another financial asset (Аверчев И.В.,2004, p.116).

Financial debt: definition and general notions

Definition of financial debt refers to:

1. Contractual obligation to give cash or another financial asset to another entity or to exchange financial assets or other financial liabilities with another entity under conditions that are potentially unfavorable to the entity or

2. A contract that will or may be settled in own equity instruments of the entity.

The contract that may be settled in own equity instruments constitute a financial instrument that imposes or may impose entity delivery of a variable number of its own equity instruments or that of a derivative that will or may be settled other than by the exchange of fixed amount of cash or another financial asset for a fixed number of equity instruments of the entity.

In category of financial liabilities representing a contractual obligation, are incorporated trade payables, notes payable, loans payable, bonds payable etc (Epstein B.J., Nach R., Bragg S.M., 2008, p.240).

Deferred revenue is not a financial liability because the outflow of economic benefits associated is the delivery of goods and services rather than a contractual obligation to deliver cash or another financial asset. Debts that are not contractual do not represent any financial liability even if involve cash payments, such as income tax and other constructive obligations that are not based on a contract, are not considered financial liabilities.

Equity instrument: demarcation and recognition

Equity instrument is any contract that certifies the presence of any interest in the assets of an entity after deducting all of its liabilities (IASB, 2009, p.1419).

An extremely sensitive issue is the demarcation of financial liabilities for equities. Analysts and accountants argue that many forms of equity instruments and financial liabilities differ essentially in a relatively small extent (Fabozzi Frank J., Franco Modigliani, 2009, p.56). As a result, they were drawn from the IASB principles that allows the issuer delineation between financial instruments as a financial liability or equity instrument, the focus is on the nature of the commitment rather than its form.

In conclusion, a financial instrument is an equity instrument only if it simultaneously meets two conditions clearly stated:

1) The instrument includes a contractual obligation to give cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under potentially unfavorable to the issuer;

2) The instrument will or may be settled in equity instruments of the issuer, in which case, should not include contractual obligation for the issuer to give a variable number of its own equity instruments or will be settled by the issuer which changes a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

These principles require that own equity instruments of the issuer to not include instruments that are themselves contracts reception or future delivery of its own equity instruments of the issuer (which found its place among the financial assets and respective indebtedness).

Conclusions

Specifics of scientific endeavor assumed is the need for demarcation, definitions and classifications in terms of accounting referentially. Thus, in the late 80s FASB and SEC identified 14 distinct categories of derivatives, which they considered to be available at that time (Huian M.C., 2008, p. 93).

Since then, however, the world of derivatives has undergone dramatic changes, not only in terms of increasing availability and trade, and the products which were once considered "exotic" gradually became common, while the novelty in terms of the structure of created products become a major competitive advantage. By far, the most beneficial trend recorded during the '90s and beyond, is the increasing importance bankers and investors give to the risk, both regulatory bodies and well-managed entities focusing on means of control of actual or potential risks exposures, and creating new components of legislation and regulations (Bryce R., 2002, p.26).

From the point of view of the explosion recorded in derivative financial instruments, it also caused some changes, making these tools not to occur only in the form of off-balance sheet assets and liabilities with reduced significance. They represent today distinct parts related to core activities reflected in the balance sheet entities, not only for banks and other financial institutions, but for a variety of other entities.

Currently, bankers, investors, regulators and financial analysts face a growing complexity of interrelations and correlations because virtually all financial instruments embedded moderns. Besides these aspects we should take into account the accounting perspective, in many cases and national regulations, disclosure of financial instruments is widespread in the notes of the financial statements, and is fully understood by a relatively small number of people. Most investors and

financial professionals are surrounded by mystery related derivatives, and often frustrated by some of their effects on the exposure it generates to the entity, and the implications on the balance sheet.

Accounting for derivative financial instruments has always created a series of debates and heated arguments between practitioners, especially on the valuation bases of derivatives used in risk covering, issues related to information presentation and gains and losses.

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