



ACCOUNTING FOR INVESTMENTS

VOLUME 1

**EQUITIES, FUTURES
AND OPTIONS**

R. VENKATA SUBRAMANI

Accounting for Investments

Volume I

Equities, Futures and Options

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R. Venkata Subramani



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*Dedicated to my respected parents,
my wife and my daughter.*

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Foreword

*A*ccounting for Investments is a complex exercise in view of the varied kinds of instruments that have emerged in the market recently. The flow of funds across the borders in the form of financial instruments is ever increasing in the global scenario. Equities, futures and options have trade life cycles, and accounting treatments on those life cycles from the front office and back office perspectives call for detailed elucidation. There are hardly any books that provide guidance in these matters. This book is a commendable effort to fill the knowledge gap that exists in the accounting of financial instruments.

International Financial Reporting Standards (IFRS), encompassing IAS 32, IAS 39, and IFRS 7, deal with the principles involved in recognition, measurement, disclosure, and presentation of financial instruments. The Institute of Chartered Accountants of India (ICAI) has come out with corresponding Accounting Standards (AS): AS 30 on “Financial Instruments—Recognition and Measurement,” AS 31 on “Financial Instruments—Presentation,” and AS 32 on “Financial Instruments—Disclosures.”

In sum and substance, the Indian Accounting Standards are the same as the corresponding IFRS. This book deals with the principles laid down in the IFRS as well as the similarities and differences between U.S. generally accepted accounting principles (GAAP) and IFRS. In that sense, one can say without fear of contradiction that this book is a comprehensive treatise of the subject.

Mr. R. Venkata Subramani is a learned person, having immense knowledge and expertise in the matters discussed in this book. The benefit of his hands-on experience and in-depth practical knowledge is reflected in the illustrations given in the various chapters. In view of the tremendous growth recently witnessed in the investment banking institutions, hedge funds, and other financial institutions, this book will become handy for understanding and capturing the entire trading process of the financial instruments. Mr. Subramani is also known as a technology wizard. Consequently, the lucid exposition that he has adopted will help in automating the system of proper accounting of the entire trade cycle of each of the financial instruments.

Investment bankers, financial institutions, dealers, brokers, professionals, and other investors will find this book immensely useful in their day-to-day operations, as Mr. Subramani explains various concepts unique to the financial instruments, besides laying down the accounting treatment in a detailed manner. This book is a useful addition to any library, serving as a source of knowledge and information with

reference to various financial products dealt with in the market. Mr. Subramani has done a splendid job in authoring this book in order to share his wealth of information and knowledge on the subject.

Mr. T. N. Manoharan
Former President
Institute of Chartered Accountants of India

Preface

Accounting for Investments attempts to give an exhaustive treatment of various accounting entries that should be recorded by any entity holding any financial asset. Over the past two decades, there have been several innovative financial instruments from the Street that call for special treatment from the accounting, legal, and regulatory perspectives. The accounting requirements are constantly being monitored and enhanced by the regulators and standard setters to provide more transparency in recording and reporting these financial products.

This book is written from the practical angle and is meant to cater to the needs of accountants as a handbook. The first volume covers equities, futures, and options. It also covers the hedge accounting treatment for equity options, depositary receipts (ADR/GDR), contract for difference (CFD), short selling, and boxed position accounting.

This book assumes that the reader already has basic accounting knowledge. Those who are entirely new to the field of accounting should refer to some basic accounting book before attempting to use this book. However, Appendix A gives an overview of the basic accounting principles and concepts.

The entire trade life cycle of each of the afore-mentioned financial assets is covered in detail with the accounting entries that should be recorded. For each illustration, the journal entries, general ledger accounts, trial balance, income statement, and balance sheet are presented to give a complete understanding of the accounting treatment. Also, for all calculated numbers, the details of such calculations are given. The notes on accounts and presentation and disclosure requirements for derivative products are covered in a separate chapter and not included for each and every illustration. Appendix C gives the complete financial statements for a sample fund with all the necessary notes on accounts and disclosures as required by International Financial Reporting Standards (IFRS).

Even though the investment banking institutions have suffered a serious setback due to the financial crisis that began in 2008, banks, hedge funds, and several other financial institutions do trade and invest in several financial instruments covered in this volume. The need for comprehensively understanding these financial instruments, including the accounting aspects involved, assumes great importance. Even before the beginning of a trading day, the front office should know the positions of the various financial instruments held by the entity and have the flexibility to obtain a detailed breakdown of cost and so on. Technology has made all this possible today at the touch of a button, and technology experts are much sought after to do the needful for these financial institutions. However, in spite of having the domain knowledge in financial products, the technology experts sometimes feel the need to have an in-depth understanding of

the entire trade life cycle with the accounting treatment that accompanies it. This book proposes to fill the knowledge gap of these aspiring technology wizards and aspiring finance and accounting professionals who want to jump into the banking and financial domain.

An overview of the trade life cycle for each financial instrument is given. However, the reader is advised to refer other resources for a detailed treatment of the trade life cycle from the front office and middle office perspective. The trade life cycle insofar as it relates to the back office—that is, the accounting aspects—is covered in detail with appropriate reference to generally accepted accounting principles (GAAP) requirements. For each financial instrument, the relevant accounting standards that are applicable are given and a comparative chart showing the similarities and differences between the U.S. GAAP and IFRS is given. While the first volume covers broadly equities, equity options, and equity futures, subsequent volumes will cover the other financial instruments.

CHAPTER ARRANGEMENT

Chapter 1—Financial Instruments

The first chapter covers the accounting standards for financial instruments and discusses the definition of *financial instruments*, *financial assets*, and *financial liabilities*. The various categories of financial instruments covered by the accounting standards are discussed along with the fair value measurement concepts. Recognition and derecognition of financial instruments is covered in brief.

The different types of investments an investor can make are outlined, even though this volume covers only investments in equity, equity futures, and equity options. The primary difference between investment and speculation is given.

The two major accounting standards—U.S. GAAP and IFRS—are discussed, giving the hierarchy of both and the measures taken towards the convergence of these standards.

Chapter 2—Accounting for Equity Investments: Trading

Chapter 2 covers accounting for equity shares held for trading purposes. After defining equity investment as per the accounting standards, the different types of investments—passive investments and investments commanding significant influence as well as controlling interest—are discussed. The broad classifications of trading and available-for-sale are given. The distinction between exchange-traded securities and over-the-counter (OTC) securities is briefly analyzed. The trade life cycle for equity shares held as trading securities is given with the accounting entries to be passed at the various stages. A comprehensive illustration of investment in long equity shares held as trading securities is covered, giving the journal entries, general ledger, income statement, and balance sheet for the illustration.

The distinction between foreign exchange (FX) revaluation and FX translation is given in great detail along with an explanation of functional currency, presentation currency, trade currency, and the requirements of accounting standards in this regard. Another illustration covers equity shares in trade currency of JPY with the functional currency of US\$, explaining the FX revaluation and FX translation processes.

The differences between trade date accounting and settlement date accounting are explained, giving the behavior of held-for-trading and available-for-sale securities on trade date, reporting date, and settlement date for various parameters like the financial asset and the liability, as well as the changes in the fair value of the financial asset.

The distinction between capital gains and currency gains and the treatment and presentation of such gains for equity shares is given in detail.

Chapter 3—Accounting for Equity Investments: Available-for-sale

This chapter covers the accounting steps required for equity shares that are held as available-for-sale. The trade life cycle for equity shares classified as available-for-sale securities is given with the accounting entries to be passed at the various stages. A worked-out illustration covers equity shares in the functional currency of US\$ held as available-for-sale. One more illustration is given on trade currency with FX translation into the functional currency of US\$.

Chapter 4—Transfer of Categories

This chapter covers the transfers from trading securities to available-for-sale securities and vice versa. It also discusses the presentation in the income statement when there is an impairment of securities as well as realized and unrealized gains or losses. When a category change happens, it also impacts the deferred tax on unrealized gain/loss, and this is explained with an illustration.

Chapter 5—Equity Derivatives: Theory

Chapter 5 explains derivatives in a financial security and lists various types of derivative contracts with the corresponding underlying variable. The definition of *derivatives* according to accounting standards is covered, and the differences between U.S. GAAP and IFRS in respect of derivative accounting are given. This chapter covers the distinction between a forward contract and a futures contract and outlines the essential components of a futures contract. The subtle differences between hedging, speculation, and arbitrage are discussed, as well as the limitations of forward markets and the advantages of futures contracts.

Open interest in derivatives contracts, the method of computing the same, and the implications of a change in open interest are discussed. Pricing of a futures contract and the cost of carry are analyzed. Stock futures and index futures and the concept of systematic and unsystematic risks are also covered in this chapter.

Chapter 6—Accounting for Equity Index Futures

This chapter covers the accounting requirements for equity index futures contracts. The salient features of a stock index and index futures are discussed with special reference to systematic and unsystematic risks. The trade life cycle for equity index futures is given with the accounting entries to be passed at the various stages.

A worked-out illustration exhaustively covers equity index futures, both in trade currency other than US\$ and in the functional currency of US\$.

Chapter 7—Accounting for Equity Stock Futures

This chapter covers the accounting requirements for equity stock futures contracts. The trade life cycle for equity stock futures is given with the accounting entries necessary at the various stages.

The worked-out illustration covers exhaustively equity stock futures, both in trade currency other than US\$ and in the functional currency of US\$.

Chapter 8—Accounting for Equity Call Options

Chapter 8 covers the accounting requirements for exchange-traded equity call options. The trade life cycle for equity long call options is given with the accounting entries necessary at the various stages. This chapter covers only the case of a call option held as a speculative position and not as a hedge against the underlying shares. The worked-out illustration thoroughly demonstrates equity long call options, both in trade currency other than US\$ and in the functional currency of US\$.

The trade life cycle for equity short call options is also covered in this chapter with the accounting entries necessary at the various stages. The worked-out illustration covers exhaustively the treatment of equity short call options in US\$.

Chapter 9—Accounting for Equity Put Options

This chapter covers the accounting requirements for exchange-traded equity put options. The trade life cycle for equity long put options is given with the accounting entries necessary at the various stages. This chapter covers only cases where the put option is held as a speculative position and not as a hedge against the underlying shares. The illustration used demonstrates equity long put options both in trade currency other than US\$ and in the functional currency of US\$.

The trade life cycle for equity short put options is also covered in this chapter, with the accounting entries to be passed at the various stages. The worked-out illustration outlines the treatment of equity short put options in US\$.

Chapter 10—Equity Options: Hedge Accounting

Chapter 10 lays out the accounting for equity options that are held as a hedge against an underlying share. The definitions of *derivative*, *financial asset*, and *financial liability* as per the accounting standards are discussed. The similarities and differences between the U.S. GAAP and IFRS insofar as they relate to derivatives and hedge accounting are discussed in various aspects like definition, initial measurement, subsequent measurement, changes in the fair value of derivative instrument, and hedge accounting criteria. The salient features of the accounting standards are covered in detail.

Specific features of the accounting standards are covered insofar as they relate to options as hedge, the rationale of hedge accounting for written options and covered calls, exception to single fair value measure rule, as well as the question of whether hedge accounting is possible for a delta-neutral hedging strategy. A table illustrates when hedge accounting is permissible as far as options are concerned.

The trade life cycle for long equity options is covered in this chapter with the accounting entries necessary at the various stages. The worked-out illustration covers exhaustively the treatment of equity put options in US\$ that are purchased as a hedging instrument against an underlying share.

Chapter 11—Accounting for Contract for Difference

This chapter covers the accounting requirements for contract for difference (CFD) contracts. Definition and product features of CFDs are covered including the concepts of margin, funding cost, interest on clear margin, and so on. The advantages and disadvantages of CFDs as an investment instrument are analyzed. The method of terminating CFDs and its effects are also discussed.

The trade life cycle for CFD contracts is given with the accounting entries necessary at the various stages. A worked-out illustration covers exhaustively a contract for difference, both in a trade currency other than US\$ and in the functional currency of US\$.

Chapter 12—Accounting for Short Equity Investments

This chapter covers the accounting requirements for short-selling, including the requirements for a box position where both the long and short positions are maintained by the investor. Typically, hedge funds are the entities that resort to this practice. Since there are some regulatory issues regarding short-selling, the investor will do well to comply with the laws of the land whenever short positions are taken. The custodian also makes sure to maintain the long and short positions separately for the investor to facilitate position reconciliation and accounting. The stock lending that is intertwined with the short position trading is also dealt with in this chapter, especially the requirements and accounting treatment of cash collateral deposited with the broker as well as the stock lending fee payments and the interest receipts relating to the cash collaterals with the broker.

Chapter 13—Accounting for ADR/GDR Investments

International depositary receipts are becoming increasingly popular, and this chapter covers the accounting treatment of American depositary receipts (ADRs). The investor usually holds positions in the same stock in both the local exchange as well as in ADRs. The stock is sold at a convenient time in the local stock exchange and to that extent the ADRs are converted into the local equity shares, incurring conversion charges. This chapter illustrates how the cost of such conversion is arrived at and how the profit on liquidation is computed and accounted.

Chapter 14—Presentation and Disclosures

Accounting standards require specific presentation and disclosure norms for financial instruments. The similarities and differences between U.S. GAAP and IFRS insofar as they relate to equity investments are given in tabular form under various topics like definition, recognition, valuation, impairment, reclassification, and so on. The disclosure requirements of both these accounting standards are given at the end of the chapter.

Appendix A—Basics of Accounting Theory

This appendix gives an overview of the basics of accounting theory, covering the basic assumptions underlying the accounting framework. It also discusses the basic accounting concepts and the basic principles of accounting. The accounting model and the elements of basic reporting are also discussed with reference to the concept statement number 6 of U.S. GAAP.

Appendix B—Accounting Standards for Financial Instruments

Appendix B gives an overview of the various accounting standards for financial instruments. It covers IAS 39—Recognition and Measurement of Financial Instruments; IAS 32—Presentation of Financial Instruments; and IFRS 7—Disclosure of Financial Instruments.

Appendix C—Financial Statements of Sample Fund

This appendix gives the financial statements of a sample fund to illustrate the concepts of presentation and disclosure requirements of the various accounting standards for financial instruments in the context of IFRS as it stands today.

Appendix D—Glossary of Technical Terms

The final appendix gives a quick reference of various technical terms that are used in the context of accounting for investments. These terms are elaborated in detail elsewhere in this book.

KEY FEATURES AND APPROACH

This book proposes to cover the domain knowledge as well as the accounting treatment for the various financial products. It should be a good addition to the library of books that deal exclusively with the treatment of all financial products handled by financial institutions, banks, hedge funds, and so on, covering the domain knowledge about the respective financial products and the accounting treatment of the same with special reference to the regulatory requirements. A one-point source of information has been needed by the financial services industry for a long time. This book proposes to fulfill that need, as part of a series of books aimed at providing that one-point reference.

Throughout this book, the approach is to give illustrations and show detailed workings of the same. Wherever there is a computed number, the details of such calculations are given even at the cost of being somewhat repetitive for some advanced readers.

INTENDED AUDIENCE

This book is intended for all those who are directly involved in different capacities and roles in the financial sector, which today is one of the largest emerging sectors in the global economy. Since this book deals with the domain knowledge of many of the exotic products that have evolved over the past two decades, it will be of interest to accountants and non-accountants alike who wish to know about the trade life cycle of these products.

For an advanced user, the book is expected to provide depth, while for a novice this book starts with the fundamentals. It starts from the basics for any financial product—defining the product, the way it is structured, its advantages and disadvantages, the different events in the trade cycle—and then discusses accounting journal entries that are passed for the same. Additionally, this book shows how the entries get reflected in the general ledger accounts, so as to give a macro-level picture for the reader to understand the basics of the effect of such accounting. Last but not the least in importance is the presentation of the results in the final accounts; the income statement and balance sheet are also well covered in this book. Thus this book is expected to be extremely useful to an expert as well as a novice, not to mention the ever increasing number of tech consultants who are in great need of such a book.

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R. Venkata Subramani

Financial Instruments

LEARNING OBJECTIVES

After studying this chapter, you should have a grasp of the following concepts:

- Accounting standards for financial instruments.
- Definition of financial instruments.
- Financial assets and financial liabilities.
- Categories of financial instruments.
- Fair value measurement concepts.
- Recognition and derecognition of financial instruments.
- Types of investments.
- Difference between investment and speculation.
- Two major accounting standards: U.S. GAAP and IFRS.
- Hierarchy of U.S. GAAP and IFRS.

ACCOUNTING STANDARDS FOR FINANCIAL INSTRUMENTS

The topic of accounting standards for financial instruments covers the following aspects:

- Definition of *financial instrument*, *financial asset*, *financial liability*, and *equity instrument*.
- Definition of a *derivative instrument*.
- Different types of contracts that are covered within the scope of the accounting standards for financial instruments.
- Four categories of financial instruments.
- Fair value and fair value determination.
- Accounting treatment of different categories of financial instruments.
- Recognition and derecognition of financial instruments.
- Initial measurement and subsequent measurement of financial instruments.
- Effect of changes in fair value.
- Reclassification and its impact.
- Impairment and its treatment for different categories.
- Hedge accounting concepts.

The synopsis of the accounting standards under the International Financial Reporting Standards (IFRS), IAS 39, is given in Appendix B.

Relevant Accounting Standards	
U.S. GAAP	IFRS
FAS 52—Foreign Currency Translation	IFRS 7—Financial Instruments: Disclosure
FAS 94—Consolidation of All Majority-owned Subsidiaries	IAS 21—The Effects of Changes in Foreign Exchange Rates
FAS 109—Accounting for Income Taxes	IAS 32—Financial Instruments: Presentation
FAS 115—Accounting for Certain Investments in Debt and Equity Securities	IAS 36—Impairment of Assets
FAS 130—Reporting Comprehensive Income	IAS 39—Financial Instruments: Recognition and Measurement
FAS 157—Fair Value Measurements	
FAS 159—The Fair Value Option for Financial Assets and Financial Liabilities	

DEFINITION OF FINANCIAL INSTRUMENTS

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Investments in equity shares are a form of financial instrument.

Financial Assets and Financial Liabilities

A *financial asset* is defined as one of the following types of assets, according to the accounting standards:

- Cash.
- An equity instrument of another entity.
- A contractual right:
 - To receive cash or another financial asset from another entity.
 - To exchange financial assets or financial liabilities with another entity under conditions, potentially favorable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
 - A non-derivative resulting in receiving a variable number of the entity's own equity instruments.
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or other financial asset for a fixed number of the entity's own equity instruments.

A *financial liability* is defined as one of the following types of liabilities, according to the accounting standards:

- A contractual obligation:
 - To deliver cash or another financial asset to another entity.

- To exchange financial assets or financial liabilities with another entity under conditions, potentially unfavorable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
 - A non-derivative resulting in delivering a variable number of the entity's own equity instruments.
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Equity Instrument

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Derivative

A derivative is a financial instrument or other contract with all three of the following characteristics:

1. Its value changes in response to the change in an *underlying*.
2. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts.
3. It is settled at a future date.

CATEGORIES OF FINANCIAL INSTRUMENTS

The four basic categories of financial instruments are:

1. Fair value through profit and loss (FVPL).
2. Held-to-maturity (HTM).
3. Available-for-sale (AFS).
4. Loans and receivables (LAR).

Investments in equity shares, futures, and equity options are classified as either fair value through profit and loss or as available-for-sale securities only. Investments in equity shares cannot be classified as held-to-maturity as there is no maturity period for equity shares. Redeemable preference shares can be classified as loans and receivables. Loans and receivables are not defined under the U.S. GAAP as a separate category, even though IAS 39 under IFRS has this category.

Fair Value through Profit and Loss (FVPL)

A financial asset or financial liability at fair value through profit or loss is one that meets either of the following two conditions:

1. It is classified as held for trading—in other words, one of the following statements is true:
 - It is acquired or incurred principally for the purpose of selling or repurchasing it in the near term.

- It is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.
 - It is a derivative other than a financial guarantee contract or for hedging purposes.
2. Upon initial recognition, it is designated by the entity as at fair value through profit or loss.

Note: Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, should not be designated as at fair value through profit or loss.

Available-for-sale

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as one of the other types of assets mentioned already, namely:

- Loans and receivables.
- Held-to-maturity investments.
- Financial assets at fair value through profit or loss.

FAIR VALUE MEASUREMENT CONCEPTS

The fair value of a financial asset or liability is the amount for which the financial asset could be exchanged, or the financial liability settled, between knowledgeable, willing parties in an arm's length transaction. The presumption is that an entity is a going concern without any intention or need to liquidate or curtail materially the scale of its operations or to undertake a transaction on adverse terms.

Hierarchy

When determining the fair value of a financial instrument, the accounting standards set out a hierarchy to be applied to the valuation. If quoted prices or rates exist in an active market for the instrument, they must be used to determine the fair value. The appropriate quoted market price for an asset held is the *bid* price, and for a liability held is the *offer* price.

Valuation Methodology

Where there is no active market available from which to draw quoted prices, a valuation technique should be used. Valuation techniques include:

- Recent market prices or rates where available, adjusted for relevant subsequent events.
- Reference to the current fair value of another instrument that is substantially the same.
- Discounted cash flow analysis.
- Option pricing models.
- A standard industry valuation technique that has been demonstrated to provide reliable estimates of prices obtained in actual market transactions.

Credit Quality

Fair value should reflect the credit quality of the instrument. For those items traded in an open market, this is likely to be incorporated in the price.

For over-the-counter derivatives, the standard approach is to value the derivative using the AA-rated curve in the valuation model. For others, the market quoted rates used in the valuation model should be adjusted for credit risk.

Any changes in the credit quality will need to be considered when remeasuring fair value.

RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

An entity should recognize a financial asset on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.

Derecognition of a financial asset or a portion of a financial asset occurs under the current standards when, and only when, the entity loses control of the contractual rights that comprise the financial asset.

An entity loses control if it realizes the rights to benefits specified in the contract; if those rights expire; or if the entity surrenders those rights.

TYPES OF INVESTMENTS

Investment can be in any of the following types of assets:

- *Physical assets.* Examples are real estate, commercial real estate, or machinery. In a real estate investment, property is purchased with the purpose of holding or leasing it for income. Commercial real estate is the owning of a building or warehouse that is rented out for business purposes.
- *Intangible assets.* These are patents, software, goodwill, and so on, and these are usually generated over a period of time. Sometimes, these assets are also purchased from another entity.
- *Financial assets.* These are often marketable securities such as investment in shares of a company or fixed-income securities like bonds. Financial assets also include investments in financial derivatives like futures and options.

In this book we explore accounting concepts involved in investment in financial assets. In particular, this volume covers investments in equities, equity futures, and equity options.

DIFFERENCE BETWEEN INVESTMENT AND SPECULATION

Speculation is the assumption of the risk of loss, in return for the uncertain possibility of a reward. If a particular position involves no risk, then such a position represents an investment.

Financial speculation involves either the buying, holding, selling, or short-selling of stocks, bonds, commodities, currencies, collectibles, real estate, derivatives, or any other financial instrument to profit from short-term fluctuations in its price, whereas buying the same asset for use or for generating a constant source of income, like dividends or interest, is regarded as an investment.

TWO MAJOR STANDARDS: U.S. GAAP AND IFRS

The United States generally accepted accounting principles (U.S. GAAP) literature is rule-based while that of the International Financial Reporting Standards (IFRS) is principle-based. Due to its rule-based nature, and also because it has been around for a longer period of time, U.S. GAAP literature is more voluminous than IFRS literature. The International Accounting Standards Commission (IASC) reorganized itself in April 2001 to form the new International Accounting Standards Board (IASB) in line with its U.S. counterpart, the Financial Accounting Standards Board (FASB), mainly with a view to get out of the International Federation of Accountants (IFA) and to interact with the leading standard setters around the globe to work on the convergence of national standards. Today, the IASB has gained a reputation as a global standard setter, with the European Union and a number of countries agreeing to adopt IFRS from 2005 onwards. The IASB has since then consistently attempted to reduce the number of options in the standards and include more guidance.

Being rule-based, the U.S. GAAP is based on conservatism and has attracted criticism that such an approach can distort the economic substance of financial statements. By contrast, IFRS, being principle-based, relies on fair value measurement principles for assets and liabilities, requiring a higher level of professional judgment.

Hierarchy of U.S. GAAP

Financial Accounting Standards (FAS) 162 came into effect in May 2008, with *The Hierarchy of Generally Accepted Accounting Principles*. By this standard, the hierarchy is being moved from auditing literature to become part of the accounting literature. The American Institute of Certified Public Accountants' (AICPA) Statement on Accounting Standards (SAS) 69, which dealt with GAAP hierarchy before FAS 162 came into existence, was criticized because it was directed to the auditor rather than the enterprise and also because it was complex. As per FAS 162, the hierarchy given is as follows:

Level	U.S. GAAP Literature
Level A	<ol style="list-style-type: none"> 1. FASB standards and interpretations 2. FAS 133 Implementation Issues 3. FASB Staff Positions 4. AICPA Accounting Research Bulletins 5. Accounting Principles Board Opinions that are not superseded by actions of the FASB
Level B	<ol style="list-style-type: none"> 1. FASB Technical Bulletins that are cleared by the FASB 2. AICPA Industry Audit and Accounting Guides and Statements of Position
Level C	<ol style="list-style-type: none"> 1. AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB 2. Consensus positions of the FASB Emerging Issues Task Force (EITF) issues 3. Topics discussed in Appendix D of EITF Abstracts
Level D	<ol style="list-style-type: none"> 1. FASB Implementation Guides 2. AICPA Industry Audit and Accounting Guides and Statements of Position not cleared by the FASB 3. Practices that are widely recognized and prevalent either generally or in the industry