

3.5 FINANCIAL ASSETS AND LIABILITIES

Definitions

1. **Financial assets** include cash, equity instruments of other entities (e.g., preference shares), contract rights to receive cash or other financial assets from other entities (e.g., accounts receivable), etc.
2. **Financial liabilities** include obligations to deliver cash or another financial asset (e.g., bonds or accounts payable), obligations to exchange financial instruments under potentially unfavorable conditions (e.g., written options), etc.

Initial Recognition

3. A financial asset or liability is initially recognized only when the entity is a party to the contract. Thus, contract rights and obligations under **derivatives** are recognized as assets and liabilities, respectively.
 - a. A **firm commitment** to buy or sell goods or services ordinarily does not result in recognition until at least one party has performed.
 - 1) However, certain contracts to buy or sell a nonfinancial item may result in recognition of an **asset or liability**.
 - a) For example, a firm commitment to buy a commodity in the future that (1) can be settled in cash and (2) is not held for the purpose of receiving the commodity is treated as a **financial instrument**. Accordingly, its net fair value is recognized at the commitment date.
 - b) If an **unrecognized** firm commitment is hedged in a **fair value hedge**, a change in its net fair value related to the hedged risk is recognized as an asset or liability.
4. An issuer of a **financial guarantee** initially recognizes a liability and measures it at fair value. **Subsequent measurement** is at the greater of (a) the amount based on accounting for provisions or (b) the amortized amount.

Derivatives

5. The value of a **derivative** changes with the change in the **underlying**. Examples are futures, forward, swap, or option contracts. The underlying is a specified interest rate, security price, foreign currency exchange rate, price index, commodity price, etc. A derivative requires **little or no initial net investment** compared with contracts having similar responses to changing market conditions. It is **settled in the future**.

Categories of Financial Assets and Liabilities

6. These categories include the following:
 - a. Financial assets or liabilities **at fair value through profit or loss (FVPL)** (unrealized gains or losses recognized in profit or loss) satisfy one of the two following criteria:
 - 1) **Financial assets or liabilities held for trading** are intended to be sold or repurchased in the near term. **Derivatives** also are deemed to be held for trading unless they are designated and effective as hedging instruments.
 - 2) Certain financial assets or liabilities that do not otherwise qualify may be designated as at fair value through profit or loss when they are initially recognized. However, fair value must be reliably measurable. This **fair value option** is available only in limited circumstances.

- b. **Held-to-maturity investments** are nonderivatives that have fixed or determinable payments and a fixed maturity. Moreover, the entity must have a positive intent and ability to hold such investments to maturity. However, this classification excludes items in the other categories.
 - c. **Available-for-sale financial assets** are nonderivatives that (1) are designated as such or (2) do not fall within one of the other classifications.
 - d. **Loans and receivables** are nonderivatives that have fixed or determinable payments but are not quoted in an active market. Potential items in this category are trade receivables, loan assets, bank deposits, and investments in debt.
7. **Initial measurement** of financial assets and liabilities, except those at FVPL, is at **fair value plus transaction costs**.
8. **Subsequent Measurement of Financial Assets**
- a. Measurement is at **fair value** with the following exceptions:
 - 1) Loans and receivables at **amortized cost**.
 - 2) Held-to-maturity investments at **amortized cost**.
 - 3) Investments in equities whose fair value is not reliably measurable at **cost**.
 - 4) Gains and losses on available-for-sale financial assets recognized **directly in equity**. The gain or loss is recognized in profit or loss when the asset is derecognized.
9. **Subsequent Measurement of Financial Liabilities**
- a. Measurement is at **amortized cost** except for financial liabilities at FVPL.

Hedge Accounting

10. An entity can mitigate a possible loss by using derivatives or other hedging instruments to offset risk. Thus, an entity is said to hedge its financial positions.
- a. The following are the kinds of designated **hedging relationships**:
 - 1) A **fair value hedge** is a hedge of the exposure to changes in fair value of a **recognized asset or liability** or **unrecognized firm commitment**. The exposure must be due to a given risk and be able to affect profit or loss.
 - 2) A **cash flow hedge** is a hedge of the exposure to variability in cash flows that
 - (a) is due to a given risk associated with a **recognized asset or liability** (e.g., interest on variable rate debt) or a **highly probable forecast transaction** and
 - (b) could affect profit or loss.
 - a) The hedge of the **foreign currency risk** of a firm commitment also may be accounted for as a cash flow hedge.
 - 3) A hedge of a **net investment in a foreign operation**.
 - b. **Criteria for Hedge Accounting**
 - 1) The hedge is formally **designated and documented** at its inception, along with the risk management objective and strategy.
 - 2) The hedge is expected to be **highly effective** and can be **reliably measured**.
 - 3) A **forecast transaction** subject to a cash flow hedge must be highly probable and be able to affect profit or loss.
 - 4) The hedge is **continually assessed** and determined to have been effective.

Accounting for Receivables

11. The **net method** records receivables net of any applicable sales discount offered as an incentive for early payment. If the payment is not received during the discount period, **sales discounts forfeited** is credited at the end of the discount period or when the payment is received.
12. The **gross method** accounts for receivables at their face amount. If a discount is taken, a sales discount is recorded and classified as an offset to sales in the income statement to yield net sales.

Bad Debt Expense

13. When an entity records sales on account, it expects that some customers will pay late or not at all.
 - a. The **allowance method** is the most common method of accounting for bad debt expense. It records the **impairment or bad debt loss** systematically. It is usually based on a percentage of either sales or the level of accounts receivable on an annual basis.
 - 1) The credit is to a **contra account**.
 - 2) As accounts receivable are written off, they are debited to the allowance. The **write-off** has no effect on working capital or total assets. The asset and the allowance are reduced by equal amounts.
 - 3) If the loss is a **percentage of sales**, the impairment is considered a function of sales on account. This approach is **income-statement oriented**.
 - 4) If the allowance is adjusted to reflect a **percentage of accounts receivable**, the impairment is a function of both sales and collections. This approach is **balance-sheet oriented**.
 - 5) A common method of estimating the loss is an analysis of accounts receivable known as an **aging schedule**. Stratifying the receivables according to the time they have been outstanding permits the use of different percentages for each category. The result should be a more accurate estimate of the recoverable amount than if a single rate is used.

Other Revenue Recognition Methods

14. The **installment method** recognizes profit on a sale when cash is collected rather than when the sale occurs. This method is used only when collection of the sales price is not reasonably assured.
 - a. Revenues and cost of sales are recognized in the period of sale. The **gross profit** is deferred to the periods in which cash is collected.
 - b. Special deferred gross profit and installment receivable accounts must be established for **each year**. The gross profit rate usually changes yearly.
15. The **cost-recovery method** may be used when (a) receivables are collected over an extended period, (b) considerable doubt exists as to collectibility, and (c) a reasonable estimate of the loss cannot be made. Profit is recognized only **after collections exceed cost**. Subsequent receipts are treated entirely as revenues.

Reducing Accounts Receivable Risk

16. Entities may transfer accounts receivable to third parties that assume the risk of nonpayment.
- a. **Assignment.** An assignment (a specific assignment) is a more formal borrowing arrangement in which the receivables are used as **security**. The assignor (borrower) signs a promissory note and financing agreement, and specific receivables serve as collateral. The assignee (lender) reduces its risk by accepting only accounts with a high probability of collection.
 - 1) Occasionally, the **debtors may be notified** to make payments to the assignee, but most assignments are not on a notification basis.
 - 2) The loan is at a **specified percentage** of the face amount of the collateral. Interest and service fees are charged to the assignor.
 - 3) **Assigned accounts** should be segregated from other accounts (debit accounts receivable assigned, credit accounts receivable), and a liability should be recognized. If the creditor may sell or repledge the collateral, it should recognize an asset and a liability.
 - b. **Factoring arrangements** discount receivables on a nonrecourse, notification basis. The receivables are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, even in the event of a loss. When the conditions for loss of control are met, a factoring arrangement is accounted for as a sale of financial assets.
 - 1) The **transferor** receives money that can be immediately reinvested into new inventories. It can offset the fee charged by the factor by eliminating its bad debts, credit department, and accounts receivable staff.
 - 2) The **factor** usually receives a high financing fee plus a fee for performing the collection. Furthermore, the factor can often operate more efficiently than its clients because of the specialized nature of its services.

EXAMPLE

Assume a factor charges a 2% fee plus an interest rate of 18% on all monies advanced to the company. Monthly sales are US \$100,000, and the factor advances 90% of the receivables submitted after deducting the 2% fee and the interest. Credit terms are net 60 days. What is the **cost to the transferor** of this arrangement?

Amount of receivables submitted	US \$100,000
Minus: 10% reserve	(10,000)
Minus: 2% factor's fee	(2,000)
Amount accruing to the transferor	<u>US \$ 88,000</u>
Minus: 18% interest for 60 days (on US \$88,000)	(2,640)
Amount to be received immediately	<u><u>US \$ 85,360</u></u>

The transferor also will receive the US \$10,000 reserve at the end of the 60-day period if it has not been absorbed by sales returns and allowances. Thus, the total cost to factor the sales for the month is US \$4,640 (\$2,000 factor fee + interest of \$2,640). Assuming that the factor has approved the customer's credit in advance, the seller will not absorb any bad debts.

The **journal entry** to record the preceding transaction is

Cash	US \$85,360	
Equity in factored receivables	10,000	
Factor fee expense	2,000	
Prepaid interest	2,640	
Accounts receivable		US \$100,000

Notes Receivable – Discounting

17. When a note receivable is **discounted** (sold), usually at a bank, the gain or loss on disposition of the note must be calculated.
18. The **holder** of the note receives the maturity amount (principal + interest at maturity) of the note minus the bank's discount. The bank usually collects the maturity amount from the **maker of the note**.
19. **Process of discounting.** The steps in discounting are to compute the
- Total interest receivable on the note (face amount × stated rate × note term).
 - Maturity amount (face amount + total interest receivable).
 - Accrued interest receivable (face amount × stated rate × note term elapsed).
 - Bank's discount (maturity amount × bank's discount rate × note term remaining).
 - Cash proceeds (maturity amount – bank's discount).
 - Carrying amount of the note (face amount + accrued interest receivable).
 - Gain or loss (proceeds – carrying amount).
- If a gain results, the entry is

Cash	XXX	
Gain on sale of note receivable		XXX
Note receivable		XXX
Interest receivable		XXX
 - If a loss results, the entry is

Cash	XXX	
Loss on sale of note receivable	XXX	
Note receivable		XXX
Interest receivable		XXX
20. If a note is discounted **with recourse**, the note must be reported as a **new financial liability**.
- The credit in the previous entry is sometimes made to **notes receivable discounted**, a contra-asset account.
21. When computing yearly interest, the day the note is received, made, etc., is not included, but its maturity date is counted.

EXAMPLE

A 30-day note dated January 17 matures on February 16. Because 14 days (31 – 17) remain in January, 16 days must be counted in February.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 16 through 22 beginning on page 152.