

New Zealand Society of Accountants
FINANCIAL REPORTING STANDARD NO. 31
1993

**DISCLOSURE OF INFORMATION
ABOUT FINANCIAL INSTRUMENTS**

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*This Standard should be read in the context of the
Explanatory Foreword to General Purpose Financial Reporting.*

*Neither an international nor an Australian accounting standard had been
issued at the time of publication of this Financial Reporting Standard.*

1 INTRODUCTION

1.1 This Standard deals with the disclosure of information about financial instruments, both assets and liabilities on and off balance sheet.

1.2 Because of the complexity of the issues about how financial instruments should be recognised and measured, the Financial Reporting Standards Board has decided as an initial approach to improve disclosures of information about, and to establish the extent and materiality of, financial instruments in use.

1.3 The accounting standards set out in this Standard are shown in bold print. Commentary is given, where appropriate, immediately after the accounting standard to which it relates, as an aid to the interpretation of that accounting standard.

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2 APPLICATION

2.1 This Standard applies to the general purpose external financial reports of all entities except where exempted by paragraph 2.2 and 2.3.

2.2 Entities which qualify for exemption in accordance with the *Framework for Differential Reporting*¹ need not comply with this Standard.

2.3 This Standard does not apply to the following financial instruments which are specifically addressed in other standards:

- (i) investments in subsidiaries, in-substance subsidiaries and associates as defined in SSAP-28, *Accounting for Business Combinations*;
- (ii) leases as defined in SSAP-18, *Accounting for Leases and Hire Purchase Contracts*;
- (iii) partnerships and joint ventures as defined in SSAP-25, *Accounting for Interests in Joint Ventures and Partnerships*;
- (iv) extinguished debt subject to the requirements of SSAP-26, *Accounting for Defeasance of Debt*.

The Standard does not amend the provisions of SSAP-21, *Accounting for the Effect of Changes in Foreign Currency Exchange Rates*, with respect to the translation of foreign currency denominated financial instruments.

2.4 This Standard becomes operative for financial reports covering periods ending on or after **31 December 1993**.

3 STATEMENT OF PURPOSE

3.1 The purpose of this standard is to improve disclosures about an entity's financial position and performance as a result of being a party to financial instruments.

4 DEFINITIONS

The following terms are used in this Standard with the meanings specified below:

4.1 A **financial instrument** is any contract that gives rise to both a (recognised or unrecognised) financial asset of one entity and a (recognised or unrecognised) financial liability or equity instrument of another entity.

4.2 A **financial asset** is any asset that is:

¹ It is anticipated that the *Framework for Differential Reporting* will be published prior to the date of initial application of this standard.

- (i) *cash;*
- (ii) *a contractual right to receive cash or another financial asset from another entity;*
- (iii) *a contractual right to exchange other financial instruments with another entity under conditions that are potentially favourable; or*
- (iv) *an equity instrument of another entity.*

4.3 A **financial liability** is any liability that is a contractual obligation:

- (i) *to deliver cash or another financial asset to another entity; or*
- (ii) *to exchange financial instruments with another entity under conditions that are potentially unfavourable.*

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

4.5 A **class of financial assets or liabilities** is a category of financial assets or financial liabilities which have a similar nature or function in the operations of the reporting entity.

4.6 A **contract** includes any agreement, commitment or obligation.

4.7 **Fair value** is the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties, in an arm's length transaction.

5 GENERAL DISCUSSION

5.1 Deregulation and competition have increasingly clouded once relatively distinct lines between various financial and predominantly non-financial entities. Many financial instruments have been developed to reduce an entity's interest rate and currency risk resulting from volatile markets by transferring risk to other entities; other instruments have been created to provide tax advantages. Many of the innovative financial instruments are a result of breaking apart or combining traditional instruments. In addition to the important economic incentives, some financial instruments have been favoured because of their financial reporting implications.

5.2 Because of the complexity of reporting issues relating to financial instruments, as an interim measure it is considered that improved disclosure is necessary to provide better information about those instruments and their use by entities. The extent of information disclosed varies according to the nature of an entity's activities and the relative importance and complexity of transactions involving financial instruments. When an entity is a party to many individual financial instruments or types of instruments, financial assets, financial liabilities and equity instruments are grouped for disclosure purposes into appropriately determined classes to avoid excessive detail in the financial statements.

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5.3 Some financial reporting issues related to financial instruments have been resolved by current accounting standards, for example, SSAP-15, *Accounting for Contingencies* and SSAP-21, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates*. However, these standards deal with specific financial reporting issues. Consequently, the specific guidance does not always apply to new financial instruments or may appear to be irrelevant if applied to similar financial reporting problems.

5.4 Parts of the definitions of a financial asset and a financial liability are recursive, because the terms financial asset and financial instrument are included in them, but they are not circular. There must be a contractual right or obligation to exchange instruments, and instruments to be exchanged must be financial assets, financial liabilities, or equity instruments.

5.5 Physical assets such as inventories, property, plant and equipment, leased assets and intangible assets such as patents, trademarks, and goodwill are not financial assets. These assets may eventually be converted to cash but, because ownership of physical or intangible assets does not create a present obligation on the part of another entity to deliver cash or another financial asset, an entity owning physical or intangible assets has no present right to receive cash or another financial asset.

5.6 Other assets, such as prepaid expenses, for which the future economic benefit is the receipt of goods or services instead of the right to receive cash or another financial asset are not financial assets. Similarly, many liabilities such as deferred revenue and most warranty obligations are not financial liabilities because the probable outflow of economic benefits associated with them is the delivery of goods and services rather than cash or another financial asset.

5.7 Contractual rights (obligations) that can be settled only by receipt (delivery) of non-financial assets, such as commodities (for example, a silver option, futures or forward contract), or the provision of services (for example, an operating lease for use of a physical asset) do not fall within the scope of the definition of a financial instrument since they do not involve a transfer of a financial asset. A contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. However, delivery of the non-financial asset or provision of the service in the future in accordance with the contract may give rise at that time to receive (and an obligation of the other party to deliver) cash or another financial asset, which right (obligation) would fall within the scope of the definition of a financial instrument.

5.8 The definition of a financial instrument includes within its scope a commodity-linked instrument that provides for the holder to receive either a financial asset, including cash, or a specified amount of a commodity. For example, a bond that allows the holder the option of receiving on maturity either

the face amount of the bond in cash or a specified quantity of oil comprises two elements, a financial asset (a receivable) and a non-financial asset (an option to exchange that receivable for oil). The intentions of the holder concerning exercise of the option do not affect the substance or the accounting treatment of the component assets.

5.9 Financial instruments result in an entity assuming or transferring to another party one or more of the financial risks described below.

Price Risk

There are three types of price risk: currency risk, interest rate risk and market risk. Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates. Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security (also referred to as event risk) or its issuer or factors affecting all securities traded in the market. The term “price risk” embodies not only the potential for loss but also the potential for gain.

Credit Risk

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

Liquidity Risk

Liquidity risk is the risk that an entity will encounter difficulty in raising funds at short notice to meet commitments associated with financial instruments (also referred to as funding risk). Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

Changes in the market’s perception of these risks give rise to fluctuations in the market price of a financial instrument. For example, the market price of a debt security is affected by changes in the market’s perception of credit risk, as well as by changes in market interest rates and, in some cases, currency risk.

5.10 Some financial instruments, both financial assets and financial liabilities, entail conditional rights and obligations that expose the entity to a risk of an accounting loss that may exceed the amount recognised in the statement of financial position. For example, the ultimate obligation under a financial guarantee may exceed the amount recognised as a liability. Other financial instruments may not be recognised as either an asset or a liability, yet may still expose the entity to an accounting loss.

5.11 Users of financial reports need information that will help them to understand the financial condition and performance of the reporting entity, the prospects for its future performance and the major aspects of its risk profile that might affect

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financial performance and condition. Dealing in financial instruments for hedging or trading purposes will affect the overall risk of the reporting entity. For each class of financial asset, financial liability and equity instrument, whether recognised or unrecognised, an entity is to disclose information about factors that may affect the amount, timing and certainty of future cash flows, including the extent and nature of the instruments and their significant terms and conditions. Financial reports that do not provide information on the significant positions in financial instruments may not show a fair presentation.

5.12 Users need two types of disclosures relating to financial instruments:

- (a) narrative or qualitative disclosures that explain the price, credit and liquidity risks to which the entity is exposed; how it evaluates these risks; its use of financial instruments to mitigate or hedge these risks; and major policies adopted to limit and control risk;
- (b) supplementary quantitative information for evaluating significant or potentially significant exposure.

5.13 Care must be taken with any disclosed quantitative data so that users will not misinterpret this information. The *Statement of Concepts for General Purpose Financial Reporting*² suggests that interpretive comments might usefully supplement the financial information supplied. Narrative disclosures in financial reports will greatly assist users in understanding the entity's use of financial instruments and the way in which the entity monitors and controls the associated risk.

5.14 As discussed in paragraph 5.2, for disclosure purposes it may be necessary to group financial instruments in appropriate classes. Classes represent groupings established in accordance with generally accepted practices that have evolved for presentation of information about financial report items having similar characteristics. In the absence of standards requiring certain groupings, management of an entity should apply its judgement to establish classes that most appropriately present financial information. Financial instruments that are grouped with other assets and liabilities should follow the same format and level of disclosure of the assets and liabilities in which they are grouped. For example, financial instruments that are aggregated with long-term liabilities should be disclosed separately in the summary of interest rates, repayment terms, etc, that are required to be disclosed by SSAP-29: *Information to be Disclosed in Company Balance Sheets and Profit and Loss Accounts*.³

² It is anticipated that the *Statement of Concepts for General Purpose Financial Reporting* will be published prior to the date of initial application of this standard.

³ An exposure draft to revise SSAP-9 (ED-67) was published in December 1992.

6 FINANCIAL REPORTING STANDARDS

General Disclosure Requirements

6.1 Entities shall disclose information about:

- (a) the accounting policies followed for financial instruments with respect to:
 - the basis for recognising revenues and expenses (including gains and losses)
 - the basis for recognising financial instruments in the financial reports or their off-balance-sheet treatment
 - the basis of valuation
 - the basis on which loss provisions are recognised for off-balance-sheet exposures;
- (b) the nature and extent of their activities with respect to financial instruments, both recognised and unrecognised; and
- (c) the policies with respect to requiring collateral or other security to support financial instruments subject to credit risk and the entity's access to that collateral or other security.

6.2 SSAP-1, *Disclosure of Accounting Policies*⁴, requires that financial reports include clear and concise statements of all significant accounting policies adopted. This is of particular importance with respect to financial instruments because of the wide variety of types of instruments that exist and the potential for different policies to be followed according to the purpose for which a particular transaction is undertaken. Also, the existence of significant exposures that may, quite legitimately, not be reflected on the statement of financial position, reinforces the need for a clear explanation of the policies followed in deciding whether an item qualifies for recognition. Matters to be addressed in the accounting policy note are to include the basis for recognising revenues and expenses, the basis for recognising financial instruments in the statement of financial position or the off-balance-sheet treatment, the basis of valuation and the basis on which loss provisions are recognised for off-balance-sheet exposures.

6.3 When an entity enters into a financial instrument transaction that is not recognised, the face or contract amount of the instrument (or the amount of any commitments or contingencies arising from contracts for which there is no face or contract amount) shall be disclosed by class of financial asset or liability.

⁴ An exposure draft to revise SSAP-1 (ED-64) was published in December 1991.

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Disclosures Concerning Credit Risk

6.4 For each class of financial asset, whether recognised or unrecognised, an entity shall disclose information about its exposure to credit risk, including:

- (a) the amount that best represents its maximum credit risk exposure, without taking account of the value of any collateral, in the event other parties fail to perform their obligations under financial instruments;**
- (b) a brief description of any collateral held; and**
- (c) significant concentrations of credit risk.**

6.5 Disclosure of the face or contract amount (or the amount of any commitments or contingencies arising from contracts for which there is no face or contract amount) of financial instruments provides a useful basis for assessing the extent to which an entity has open contracts at balance date resulting in exposure to risk in excess of the amounts recognised in the financial reports. The face or contract amounts also give users of financial reports an indication of the relative significance of financial instruments that are not recognised in the financial statements even though the face or contract value may not represent amounts at risk. The risk of default depends on the creditworthiness of the counter-party to the instrument and can be measured only when all related and off-setting transactions are identified. For purposes of disclosure financial assets and liabilities are to be offset only if the criteria for offsetting recognised items, discussed in SSAP-27, *Right of Set-Off*, are met.

6.6 The amount of the accounting loss that would be incurred if the counterparty to a financial instrument failed to perform its obligations and any collateral held proved to be valueless provides a measure of the maximum possible credit loss. For a financial instrument for which the credit risk is not off-balance-sheet (for example, a non-interest bearing trade account receivable) the carrying amount in the statement of financial position is the accounting loss that would be incurred in the event of default by the counterparty. The caption used to describe such financial instruments implies the existence of credit risk. For some financial instruments, however, the maximum accounting loss may exceed the recognised amount, perhaps by a significant margin. Loan commitments and financial guarantees are examples of unrecognised financial instruments with significant risk. While it is not expected that an entity will incur the maximum possible credit loss for unrecognised financial instruments, disclosure of this amount provides important information for analysis that is not otherwise available within the statement of financial position.

6.7 For financial institutions, disclosures of risk weighted balance sheet and off-balance sheet exposures calculated for capital adequacy requirements may best represent the entities maximum exposure to credit risk.

6.8 Concentrations of credit risk may arise from exposures to a single counterparty or to groups of counterparties having a similar characteristic such that their ability

to meet their obligations would likely be similarly affected by changes in economic or other conditions. Examples of similar economic characteristics that would be considered to give rise to a concentration of risk include the nature of the activities undertaken (such as, the industry in which counterparties operate, and the geographic area in which activities are undertaken). Identification of significant concentrations is a matter for the exercise of judgement by management taking into account the circumstances of the entity.

6.9 Disclosure of information about concentrations of credit risk permits users of financial reports to make their own assessments of the relative risk associated with an entity's portfolio of financial assets. Whether a particular concentration of credit risk is viewed favourably or unfavourably will depend on the particular risks associated with an individual counterparty or group of counterparties.

6.10 Information about an entity's requirements with respect to collateral or other security to support financial instruments subject to credit risk is useful because the existence of collateral may mitigate the risk of loss as a result of default. Disclosure may therefore assist users of financial reports in assessing the appropriateness of an entity's policy with respect to collateral and the likely adequacy of collateral held in the event of default.

Disclosures Concerning Fair Value

6.11 The fair value of each class of financial assets and financial liabilities, whether recognised or unrecognised, together with their financial report carrying amounts, shall be disclosed unless it is not practicable to estimate that value with an acceptable level of reliability within constraints of timeliness and cost. When the fair value of any financial assets or liabilities cannot be estimated, this fact shall be disclosed together with information about the principal characteristics of the instruments that are pertinent to their value.

6.12 Current value information provides a useful measurement of unrecognised financial instruments and a useful additional measurement of recognised instruments that are carried on a cost or amortised cost basis. It is particularly useful when viewed in conjunction with financial report carrying amounts. Comparisons of the fair value and the carrying amount provide information about unrealised gains and losses not recognised in the financial reports. Information about current market values of liabilities as well as assets may be particularly relevant to an evaluation of the performance of a financial institution in structuring its portfolio to match changes in the value of assets with corresponding changes in the value of liabilities.

6.13 When a financial asset or liability is traded in an organised and liquid market that is able to absorb a significant transaction without moving the price against the trader, quoted market prices would be used to measure fair value. When quoted market prices are not available, techniques for estimating fair value, such as

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discounting estimated future cash flows at a current market rate commensurate with the risks involved, are to be used. In some cases, estimation of fair value may not be practicable within acceptable levels of reliability and at a reasonable cost. For example, the cost of making a reasonably reliable estimate of the fair value of the loan portfolio of a financial institution may be excessive in relation to the perceived benefits to users. In such situations, disclosure of fair value information may be omitted with an explanation of the reason for the omission and additional information about the principal characteristics of the instruments that are pertinent to their value. The latter information may assist users of the financial reports in making their own judgements about the likely significance of any difference between fair value and the carrying amount.

Disclosures Concerning Currency Risk and Interest Rate Risk

6.14 For each class of financial asset and liability, whether recognised or unrecognised, an entity shall include discussion of major management policies and information about its exposure to currency risk and to interest rate risk, including:

- (a) effective interest rates; and**
- (b) contractual repricing or maturity periods, whichever periods are earlier.**

6.15 Information about effective interest rates and expected repricing or maturity dates indicates the length of time for which interest rates are fixed at present levels. This is important because it provides a basis for evaluating the interest rate risk to which an entity is exposed. For example, two fixed rate bonds may be identical in every respect except for the remaining term to maturity, a difference which may expose the issuers and the holders of the two bonds to markedly different price risk. All things being equal, the bond with the longer term remaining to maturity will be subject to greater price risk in the event of a change in interest rates. While knowledge of the remaining term to maturity may be sufficient to assist in evaluating interest rate risk when an entity issues or holds fixed rate instruments, many instruments reprice to a market rate of interest before maturity.