

## IFRS reporting – Matters arising on Derivatives

It is over six years that Nigeria adopted the International Financial Reporting Standards (IFRS) to align the country with global reporting. Initially, there was deep apprehension around the success potentials of the implementation roadmap. Some people/entities thought that the road map may be hitched and may have to be suspended at a point in time; but that is not the reality at this moment. The reality is that IFRS reporting has debuted successfully and every stakeholder (private and public sector) is expected to hone their understanding and skills for compliance with this global reporting framework.

This week our focus is on derivative financial instruments and our readers are expected to relate the theories to actual implementation results to ensure that identified gaps are addressed. I do not envisage a material gap that may trigger the application of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. However, where material gaps are identified, it will be imperative to notify those charged with governance in the organisation and the Independent Auditors.

All derivatives are accounted for in the statement of financial position at fair value, irrespective of whether they are used as part of a hedging relationship. Changes in fair value are recognised in profit or loss unless the contract is designated in an effective hedging relationship under which some or all of the derivative gains and losses are required to be presented in other comprehensive income.

The definition of a derivative is broad enough to scope in contracts that were not intended to result to a derivative financial instrument. But, by nature of the wording of the contract and available documentation, a derivative instrument could ensue. This involuntary derivative instrument could be very costly to the organisation if the counterparty intended the contract to be a derivative or decided to capitalise on the professional ineptitude of the other counterparty. In instances of mutual misunderstanding, contracts could be redrafted at the transition date. This window



is not available post IFRS transition. It is imperative to seek independent accounting opinion and/or legal opinion (from a practitioner that is registered under FRCN Act, 2011) on complex financial transactions.

At this post-implementation phase, there is need to revisit the sections on recognition, measurement, and classification of financial instruments in the entities' IFRS accounting manual. Entities without IFRS accounting manual are expected to fix this gap and ensure that the manual is available to all financial reporting personnel.

The manual must be clear on the need to have ALL of the three characteristics that must be present in a financial instrument or other contracts to qualify for a derivative:

- its value changes in response to the change in a specified referenced item (called the 'underlying');
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement amount of a derivative.

When the features do not meet the definition of a derivative, consideration will need to be given to the implications of this on the computation of the effective interest rate when the feature is included in a contract that

is a debt instrument that is a liability in the scope of IFRS 9.

### Notional amount and payment provisions

A notional is often an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. A payment provision is a provision which requires a fixed payment or payment of an amount that can change as a result of some future event that is unrelated to a notional amount. Neither a notional amount nor a payment provision is an essential characteristic of a derivative instrument; derivative instruments usually contain a notional amount or a payment provision each of which may interact with the underlying to determine the settlement amount of the derivative instrument.

### Interaction of the notional amounts with the underlying

The settlement amount of a derivative instrument with a notional amount is determined by the interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants.

### Initial Net Investment

The second part of the definition of a derivative is that there is either no initial net investment, or that any initial investment is smaller than would be required for other similar contracts with comparative market sensitivity. This is a comparative measure and excludes all margin accounts.

Margin accounts are a form of collateral for the counterparty or clearing house and may

take a form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

### Future Settlement

The third part of the definition of a derivative is that it is settled at a future date. Settlement can occur in different ways, either gross or net, and does not just mean exchange of cash. However, expiry of the contract is a form of settlement, even if at maturity of the instrument no cash or underlying changes hands.

### Practical Issues

#### Ambiguities in financial instruments

At times, the settlement amount in a derivative contract can be dependent on a non-financial underlying such as a disaster index of an earthquake in a particular region or climatic/geological condition such as temperature in a particular region. Parties to derivative contracts whose underlying variables are referenced to non-financial variables often do not understand the implications of such terms at the inception of the contracts.

#### Underlying instruments in another economy

Another challenge often encountered in valuation of derivatives contracts is the setting of financial variables which are outside the primary economic environment of one of the parties to the contract. This is very common in cross-border convertible loan contracts which often has options contracts embedded therein. The settlement amount might make reference to a financial variable in another economy which would amount to a gain

to one party that has better understanding of the workings of the host environment.

#### Unavailability of historical information on financial variables – private entities

Financial variables in some derivative contracts often make reference to the share prices of private companies whose share prices are not available to the public, this makes pricing and valuation of derivatives very cumbersome. In cases like this, valuation of such contracts might require periodic valuation of the underlying - stocks of the private entities.

#### Non-engagement of financial consultants at inception of the contract

Based on our experiences, we have realised that at least one party to a hybrid contract, most likely the recipient of loans, only often cares about the loan amount that is going to be granted at the inception of the contract. Such party only often engage the services of a legal adviser without deeming it fit to engage the services of a financial consultant who would determine the financial implications of every clause in the contract. More often than not, the way a legal adviser views a clause is different from the way a financial consultant will view it. The concept of substance of the transaction over its legal form comes into play when recognising the transaction.



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