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Financial Reporting Standards on Financial Instruments Issued

Two Exposure Drafts dealing with financial instruments have recently been launched by the Indonesian Institute of Accountants as Statements of Financial Accounting Standards ("PSAK") 50: Financial Instruments – Presentation and Disclosures (Revised 2006) and PSAK 55: Financial Instruments – Recognition and Measurement (Revised 2006).

The new PSAKs are based on International Accounting Standards ("IAS") 32 and 39 of the same titles. The new PSAKs carry forward virtually all provisions under the Exposure Drafts (discussed in PwC Newsletter dated December 2006) with little or no change.

Significant features of the revised PSAK 50 and PSAK 55 are as follows.

Financial assets - definition and classification

PSAK 50 Revised ("PSAK 50R") defines a financial instrument as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. A financial asset is defined as cash; a contractual right to receive cash or another financial asset; a contractual right to exchange financial assets or liabilities with another entity under conditions that are potentially favorable; or an equity instrument of another entity.

Under PSAK 50R there are four categories of financial asset:

- At fair value through profit or loss ("FVTPL") – all financial assets acquired for the purpose of generating a profit from short-term fluctuations in price, or part of a portfolio with a pattern of short-term profit taking; or those financial assets designated in this category by management at initial recognition.
- Held-to-maturity – non-derivative financial assets with fixed or determinable payments and maturity that an entity has the positive intention and ability to hold to maturity (conditions for this category are tightly defined);
- Loans and receivables – non-derivative financial assets with fixed or determinable payments that are not quoted in an active market;
- Available-for-sale – the remainder; or those financial assets designated in this category by management.

Reclassifications of financial instruments are more restricted under PSAK 55R compared to the previous version of PSAK 50. For example, reclassifications into or out of financial assets measured at FVTPL are not allowed. In addition, when an investment originally designated as held-to-maturity is later sold there is now a tainting rule which states that any remaining held-to-maturity investments should be reclassified as available-for-sale assets for the two financial years which follow.

Derecognition of a financial asset

PSAK 55R implements a stricter rule when a company wants to "derecognize" or remove a financial asset (for example, a receivable or an equity investment) from its balance sheet. In particular the company should consider:

- whether the rights to the cash flows of the financial assets have expired;
- whether the company has transferred its right to receive the cash flows from the financial assets;
- whether the entity has assumed an obligation to pay the cash flows from the financial assets;
- whether the company has transferred substantially all risks and rewards;
- whether the company has retained substantially all risks and rewards;
- whether the company has retained control of the financial assets.

These requirements will restrict the ability of securitized assets to be derecognized in the financial statements.

Impairment of a financial asset

PSAK 55R might also change the way a company (for example, a bank) calculates the impairment of a financial asset (for example, a loan provided to a customer). This poses a challenge for many companies including Banks due to a general lack of available data to prepare an 'incurred loss' provisioning model.

Impairment of a financial asset should only be conducted when there is objective evidence that a loss has been incurred, rather than based on expectation of losses.

Financial liabilities – definition

Items are classified as financial liabilities when the issuer has a contractual obligation to deliver cash or another financial asset to the holder of the instrument or to issue a variable number of their own shares to settle a fixed amount, regardless of its legal form (for example, mandatorily redeemable preference shares should be classified as liabilities).

PSAK 50R offers guidance on how to differentiate a financial liability from an equity instrument. This guidance will be particularly useful for determining the classification of a financial instrument that seemingly has the characteristics of both a liability and an equity. When a financial instrument contains both a liability and an equity component (called "a compound instrument"), each component should be classified and presented separately.

Offsetting a financial asset and a financial liabilities

Under PSAK 50R, offsetting of a financial asset and a financial liability is severely restricted only when there is a legally enforceable right to offset the amounts and there is an intention to settle the amounts on a net basis or simultaneously.

Disclosures relating to financial instruments

PSAK 50R requires far more comprehensive disclosures than currently required by the existing PSAK 50 and 55. Among other things it requires disclosure of relevant risks such as market risks (that comprises foreign currency risks, interest rate risks and price risks), credit risks and liquidity risks. The standard also mandates disclosure of the company's risk management and hedging policies, the nature of financial instruments and their fair values.

Derivatives

PSAK 55R provides a definition of a derivative that is broadly similar to that under the previous version PSAK 55R which is that when there is an underlying, the instrument requires little or no net investment and it is settled at a future date.

All contractual rights or obligations under derivatives should be recognized on the balance sheet as financial assets or liabilities. Gains and losses on derivatives should be recognized in the income statement unless they qualify for cash flow or net investment hedge accounting; in this case, such gains and losses are deferred in equity.

Similar to the previous version of PSAK 55, the new standard also discusses embedded derivatives. An embedded derivative is a component of a combined financial instrument that also includes a non-derivative host contract, with the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative. Embedded derivatives that are not closely related to the host contract must be separated from the host contract and accounted for as stand-alone derivatives.

Hedge accounting

PSAK 55R provides guidance on hedge accounting that is broadly similar to that under the previous version of PSAK 55. To qualify for hedge accounting, an entity should (a) document at the inception of the hedge the relationship between hedging instruments and hedging items; and (b) have the risk management objective and strategy for undertaking various hedge transactions.

The entity should document its assessment, both at hedge inception and on an ongoing basis, of whether the hedging instruments that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

Hedging instruments can generally be used as: (a) hedges of the fair value of recognized assets or liabilities, or a firm commitment; or (b) hedges of highly probable forecast transactions (cash flow hedges) or hedges of net investment in foreign operations.

Gains and losses on instruments qualifying as cash flow hedges are included in equity and recycled in the income statement when the hedged item affects the income statement, or they are used to adjust the carrying amount of an asset or liability at acquisition. Hedges of a net investment in a foreign operation should be accounted for similarly to cash flow hedges. For a fair value hedge, the hedged item is adjusted for the gain or loss attributable to the hedged risk, and that element is included in income to offset the income statement impact of the hedging instrument.

PSAK 50R and PSAK 55R is effective for financial statements covering periods beginning on or after 1 January 2009. Earlier adoption is recommended.

Contacting PricewaterhouseCoopers

If you have any concern or question regarding matters in this NewsFlash, please contact your engagement partner or PricewaterhouseCoopers' Technical Committee:

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