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SYNOPSIS OF IFRS 7 (FINANCIAL INSTRUMENTS) IN FINANCIAL REPORTING

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Abstract

The purpose of this paper is to examine the value relevance of financial instruments disclosures (FID) provided by companies under International Financial Reporting Standard (IFRS 7) as IFRS 7 financial disclosures is very important for entities that hold financial instruments as it provide stakeholders – Investors critical understanding of entities' credit position and risk potentials thereby enhancing transparency and comparability of financial statements. Entities year-end financial position disclosures, income statements and equity disclosures, hedge accounting disclosures, fair value disclosures, financial risks and its management and sensitivity analysis disclosures criteria were examined.

Key words: Transparency, Accountability, IFRS, Sensitivity, Disclosure, Standard.

1.0 Introduction

Arising from the financial failures, manipulation of accounting records via creative accounting devices there is the call for robust accounting standards. Also the opinion that disclosures about risk should be part of the financial statements since financial statements would be incomplete and potentially misleading without disclosures about risks arising from the financial statements (Ewa and Eseneyen, 2021) emphasised the need for risk management concepts in financial reporting. In fact, the increase in corruption and poor corporate governance globally and Nigeria in particular, the technique used by entities for measuring and managing exposure to risks coming from financial instruments have evolved and new risk management concepts and approaches have gained acceptance or recognition. Many public and private sector initiatives have suggested improvements or upgrade to the disclosure framework for risks arising or occasioned from financial instruments.

The International Accounting Standard Board (IASB) believes that users of financial statements need information about an entity's exposure to risks and how those risks are managed. It is the mission of IASB to develop International Financial Reporting Standards (IFRS Standards) that bring transparency, accountability and efficiency to financial markets around the world, (Pacter, 2016). It is presumed that such information can influence a user's assessment of the financial position as well as financial performance of the entity or of the amount, timing and uncertainty of its future cash flows. It is considered that an aggressive transparency crusade regarding these risks will allow users to make more informed decisions about risks and return. Consequent upon the above, IASB resolved to revise and enhance the disclosures in International Accounting Standard (IAS) 30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions and IAS 32 (Financial Instruments: Disclosure and Presentation) and remove all duplicative disclosures in the standards and simplify the disclosures about concentration risks, credit risks, liquidity risks and market risks.

1.1 Objective of study

The objective of the paper is to highlight what this standard on financial instruments (IFRS 7) requires an entity to disclose in its financial statements that will enable users to evaluate the significance of financial instruments for the entity's financial position and its performance. This is necessitated as study results indicated that investors value financial instrument (FI) related information when making their equity pricing decisions and also compliance with IFRS mandatory disclosure requirements do produce relevant financial statements, (Tahat, Y; Dunne, T; Fifield, S. & Power, D; 2016). Furthermore, the nature and extent of risks arising from financial instruments to which an entity is exposed to during the period and at the reporting date, and how the entity manages those risks, Similarly, some studies posit that banks are more prudent in loan offering that helps reduce risk and the market discipline view of bank risk disclosure improve financial stability, (Lobo, G. J; Wang, C. & Feng (Harry), W. (2024).

1.2 Scope of study

International Financial Reporting Standard (IFRS 7) applies to all risks arising from all financial instruments except the below instruments:

i. Those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IAS 27 (Consolidated and Separate Financial Statements), IAS 28 (Investments in Associates) and IAS 31 (Interest in Joint Ventures).
ii. Employers' rights and obligations arising from employee benefit plans to which IAS 19 (Employee Benefits) applies.
iii. Contracts for contingent consideration in a business combination in IFRS 3 (Business Combinations). Here the exemption applies to the acquirer.
iv. Insurance contracts derivatives as defined in IFRS 4 (Insurance Contracts)
v. Financial instruments contracts and objections under share-based payment transactions to which IFRS 2 (Share-Based Payments) apply except contracts within the scope of paragraph 5-7 of IAS 39 (Financial Instruments: Recognition and Measurement)

Entities are required in their determination of classes of financial instruments and their level of disclosures as stated in the standard to group the financial instruments into classes that are appropriate to the nature of the information disclosed ensuring to take into account the characteristics of those financial instruments.

Sufficient information to permit reconciliation to the line items presented in the balance sheet must be provided by the entity. The information being disclosed should enable users of the financial statements to evaluate the significance of financial instruments for the entity's financial position and performance.

The standard adoption applies to all entities including entities that have few financial instruments like manufacturing companies that may have account receivable and account payable as the only financial instrument in the financial statements.

1.3 Disclosure as per the standard

The standard prescribed the following disclosures in any financial statement concerning financial instruments:

1. **Balance sheet (Statement of Financial Position) disclosures**

Financial assets and financial liabilities should be disclosed by the measurement categories. By this, users understand the extent to which accounting policies affect the amount at which financial assets and financial liabilities are recognised at the discretion of the entity. The following elements are important components:

i. Disclosure of non-derivative financial liabilities at fair value as under financial assets and financial liabilities at fair value through profit or loss that are subject to rights of set-off and related arrangements.

ii. Disclosure of compound financial instruments with multiple embedded derivatives that have interdependent values.

iii. Disclosure of defaults and breaches of loans payable and other loan agreements.

iv. Reclassifications and stating reasons for the reclassification of financial asset at cost or amortized cost, rather than at fair value stating reason(s) for the reclassification and amount reclassified into and out of each category.

v. De-recognition disclosure as an entity may have transferred financial assets in such a way that part or all of them do not qualify for recognition.

vi. Disclosure of collateral item(s) an entity holds if it is permitted to sell or re-pledge the collateral in the absence of default by the owner

vii. Disclosure of allowance account for credit losses.

11. Income Statement and Equity Disclosures

i. Items of income, expenses, gains or losses by the measurement categories.

ii. Fee incomes or expenses arising from financial assets or liabilities and from trust and other fiduciary activities that result in the entity holding or placing assets on behalf of individuals, trust, retirement benefit plans and other institutions.

111.Other disclosures

i. When entities do not measure a financial asset or financial liability in its balance sheet at fair value, it should provide fair value information through supplementary disclosures to assist users to compare entities on a consistent basis.

ii. In line with IAS 1 standard on Presentation of Financial Statements, entities should disclose in the summary of significant accounting policies, the measurement basis used in preparing the financial statements and the other accounting policies used that are relevant to understanding the financial statement.

2.0 Hedge Accounting Disclosure:

If an entity applies hedge accounting, IFRS 7 requires disclosures about the hedging instruments, the hedged items, and the effectiveness of the hedge. Entities are therefore to disclose the following separately for each type of hedge as described in IAS 39:

a) Fair value hedges
b) Cash flow hedges
c) Hedges of net investments in foreign operations.

2.1 Under fair value hedges:

i. A description of each type of hedge
ii. A description of the financial instrument designated as hedging instruments and their fair values at the reporting date
iii. The nature of the risks being hedged

2.2 Under Cash flow hedges

i. The period when the cash flows are expected to occur and when they are expected to affect profit or loss
ii. A description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur.
iii. The amount that was recognised in equity during the period
iv. The amount that was removed from equity and included in profit or loss for the period showing the amount included in each line item in the income statement.
v. The amount that was removed from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedge highly probable forecast transaction.

2.3 Under hedges of net investments in foreign operations:

i. In fair value hedges, gains or losses on the hedging instrument and on the hedged item attributable to the hedged risk.
ii. The ineffectiveness recognised in profit or loss that arises from cash flow hedges
iii. The ineffectiveness recognized in profit and loss that arises from hedges of net investments in foreign operations.

3.0 Fair Value Presentation

For each of the financial assets and financial liabilities, the entity should disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. Here in disclosing fair values, entities should group financial assets and financial liabilities into classes but should offset them only to the extent that their carrying amounts are offset in the balance sheet.

Entities should disclose methods and when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities.

Also entities should disclose whether fair values are determined in whole or in part directly by reference to published price quotations in an active market or are estimated using a valuation technique.

Entities should also disclose whether the fair values recognized or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument and not based on available observable market data.

4.0 Location of Disclosures of Risks from Financial Instruments

Disclosures about risk should be part of the financial statements as financial statements would be incomplete and potentially misleading without disclosures about risks arising from financial statements.

4.1 Management and types of Risks

IFRS 7 requires entities to disclose information that will enable users of their financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entities are exposed at the reporting date. This disclosure may be qualitative or quantitative disclosures.

Qualitative disclosures involves disclosing the exposures to risk and how they arise, objectives, policies and processes for managing the risk and the methods applied to measure the risk and any changes made in above from the previous period.

Quantitative disclosure involves summarising quantitative data about the entity's exposure to the risk at the reporting date in respect of borrowing cost, credit risks, liquidity risk and market risk and the concentrations of the entity's other entity's risk not considered as credit risk, liquidity risk or market risk. These risks include:

1. **Credit Risk**: The risk is an economic loss that a party to a financial instrument will cause to the other party by failing to discharge his obligation to the credit agreement.
2. **Liquidity Risk:** The risk associated with difficulty in meeting obligations associated with financial liabilities like loans payable. It is the risk of difficulty or difficulties that an entity will encounter in meeting obligations associated with financial liabilities, (Mohammed, 2024).
3. **Market Risk**: That risk that the fair value or future cash flows of a financial instrument will change or fluctuate due to changes in market prices. It is the risk that a financial instrument's fair value or future cash flows will fluctuate because of changes in market prices. This risk comprises interest rate risk, currency risk and other price risk.

4.2 Sensitivity Analysis:

Entities must provide a sensitivity analysis for each market risk to which they are exposed, showing how profit or loss and equity would have been affected by reasonably possible changes in relevant risk variables.

5.0 Conclusion

The International Financial Reporting (IFRS) 7 - Financial Instruments: Disclosures, is important for entities that hold financial instruments. It affords users of financial statements with critical understandings into their significance and risks potentials. By making sure that entities disclose relevant information about their financial instruments and risk management practices, the standard thus enhances the transparency and comparability of financial statements.

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