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The Impact of Financial Instruments on the Financial Statements in light of the Application of the Financial Reporting Standard

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Abstract:
The researcher believes that the financial statements must include all additional disclosures if this leads to increased clarity of the financial instruments to the users of the financial statements. It may be desirable to disclose some information, as a gain or loss resulting from remeasuring the financial instruments for the purposes of Sale at fair value (except for assets related to hedging) through a statement of changes in equity, the amount that was recognized in equity during the current period and the amount that was excluded from equity and reported in the net profit or loss for the period must be disclosed, and the Assessing assets available for sale or for trading purposes that are reliably valued at fair value, disclosing the amortized cost for assets held to maturity, and explaining the reasons why it is not possible to measure fair value reliably. As well as disclosing the selling value of assets that were sold and whose fair value could not previously be measured reliably, disclosing the amount of the recognized gain or loss, and disclosing the reasons for reclassifying a financial asset as being valued at amortized cost and not at fair value.

Keywords: financial, instruments, reporting standard

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1. Introduction

Since 1973, the American Financial Accounting Standards Board (FASB) has held the mandate for establishing accounting and financial standards in the United States of America. Initially established as an official body through Financial Circular or Issue No. 1 by the Securities Exchange Commission, its authority was further solidified by Rule 203 and the Conduct Rules issued by the American Institute of Certified Public Accountants (AICPA) in 1965. The AICPA, in response to recommendations from the Special Committee and views expressed by the Accounting Principles Board (APB), emphasized the need to enumerate and define the objectives, concepts, principles, and terminology of accounting.

This call for clarity and standardization was echoed in Bulletin No. 4 of the Accounting Principles Board titled "Basic Concepts and Inherent Accounting Principles for the Financial Statements of Business Enterprises." The statement aimed to enhance understanding of accounting fundamentals and establish a framework for accounting development. While descriptive in nature, it organized generally accepted accounting principles based on observed accounting practices. Despite its intention to contribute to a more cohesive and comprehensive structure for financial information, the statement did not offer specific solutions to accounting issues or prescribe what constitutes generally accepted accounting principles.

In 1971, the AICPA convened a committee to delve into the objectives of financial statements. This committee identified twelve objectives and seven qualitative features for financial reports, marking a significant step in refining the purpose and quality of financial reporting [1].

1.1. Special features of bonds

Here are some examples of strategies for using bonds with unconventional features [2]:

1) **Bail-In Bonds:** These bonds are issued by banks as a means to acquire other banks or to provide financing to struggling banks. They typically offer high returns but come with high risk due to the financial instability of the issuing bank.
2) **Callable Bonds:** Banks may issue bonds with lower interest rates but grant the holder the option to purchase additional bonds with the same interest rate on a specified future date. These bonds are attractive to investors anticipating a decrease in interest rates.
3) **Puttable Bonds:** Banks issue bonds with the option for the holder to sell the bond back to the issuing bank at book value after a predetermined date.
4) **Floating Rate Bonds:** Banks issue bonds with a variable interest rate instead of a fixed rate, adjusting every six months relative to another interest rate, such as the Treasury rate. This strategy is employed when banks anticipate a decline in interest rates.
5) **Zero-Coupon Bonds:** These bonds are sold at a discount to face value and do not pay periodic interest. Instead, the difference between the purchase price and the face value represents the return to the buyer. This benefits the issuing bank by eliminating the need to pay regular interest.
6) **Income Bonds:** Bonds are issued by banks with the provision to pay interest to the holder only when the bank generates income. In periods when the bank does not earn income, bondholders may forego receiving interest payments.

"Bad type" bonds are issued by banks with the intention of acquiring other banks or providing financial support to struggling banks. These bonds are known for their high return potential but also carry a high level of risk. They are often employed in situations where a bank seeks to expand its operations through acquisition or when it aims to assist financially distressed institutions. Due to the inherent risks involved, investors must carefully evaluate the potential returns against the associated risks before investing in such bonds [3].

2. Method

This qualitative study investigates essential disclosure practices in fair value measurement within financial reporting. It begins with a comprehensive review of scholarly literature and regulatory guidelines on fair value measurement and disclosure practices. Data is then collected from financial statements, disclosure notes, and annual reports of publicly traded companies to identify relevant disclosure practices.

Next, rigorous content analysis is conducted to discern patterns, trends, and variations in disclosure practices. Comparative analysis is employed to contrast disclosure practices among different entities and industries, identifying best practices and areas for improvement.

Finally, findings are interpreted and synthesized to draw meaningful conclusions about the importance and impact of essential disclosure practices in enhancing the transparency and reliability of fair value measurements in financial reporting. Through this methodological approach, the study aims to provide valuable insights into fair value measurement disclosure practices.

3. Results and Discussion

3.1. Objectives of the financial statements according to the International Financial Reporting Standard (IFRS7) Financial Instruments - Disclosures

Statement SFAC 1 delineates the objectives of financial statements, underscoring that these objectives encompass all forms of communication pertaining to accounting information, extending beyond traditional financial statements and reports. This broader concept includes various channels of information dissemination, such as the bank's annual reports, forecasts, financial reports submitted to the stock exchange, as well as news releases, management forecasts, and communications with regulatory agencies [4].

1) Offering valuable insights for commercial and economic decision-making: Financial information caters to both internal and external users. Internally, it aids management and bank personnel with detailed insights crucial for operational decisions. Externally, it serves individuals with direct or indirect economic interests in the bank, including investors and stakeholders represented by intermediaries.
2) Furnishing understandable data to aid in forecasting the bank's cash flows: Investors and creditors rely on information regarding cash flows to anticipate the bank's ability to meet financial obligations and distribute dividends. These expectations significantly influence the market valuation of the bank's shares and bonds.
3) Providing comprehensive information concerning the bank's economic resources, liabilities, and the impacts of transactions: Financial statements offer insights into the bank's assets, liabilities, and how various transactions, events, and circumstances affect these resources and liabilities over time.
4) Facilitating decision-making for investors and creditors regarding their stake in the bank: Financial statements empower investors and creditors to make informed decisions concerning their investments and loans by providing transparent and reliable data about the bank's financial performance and position [5].
5) Equipping stakeholders with essential information to estimate expected net cash flows, considering inherent uncertainties: Financial statements offer data crucial for projecting future cash flows, considering the uncertainties inherent in financial markets and economic conditions. This information aids stakeholders in making well-informed decisions despite the unpredictable nature of future cash flows [6].

3.2. Qualitative characteristics of information according to IFRS7

The demand for accounting information from stakeholders such as investors, lenders, and creditors necessitate the establishment of qualitative characteristics to ensure the usefulness and reliability of such information. These characteristics are fundamental for evaluating the quality of accounting information. From these, two primary qualitative characteristics emerge, each branching into three sub-characteristics. Additionally, two complementary, or secondary, characteristics further enhance the overall quality of accounting information.

- *Main qualitative characteristics*

  The following statement outlines the primary characteristics and types of accounting information [7]:

  1) **Relevance:** a fundamental aspect of accounting information, it encompasses its relevance, indicating its capacity to influence the economic decisions of its users. The more pertinent the information, the more valuable it becomes. Relevance comprises several characteristics [7,8]:
     a. **Predictive value:** This aspect denotes the ability of financial information to forecast potential future events. Information possesses

predictive value if it aids investors in forming expectations about future developments.

b. **Confirmatory value:** It pertains to information that confirms or rectifies past events, offering users insights into historical occurrences. Confirmatory value is essential for validating or adjusting previous expectations.

c. **Relative importance:** The significance of information lies in its potential to impact user decisions. Materiality is determined by individual banks, considering the nature and magnitude of the elements involved. If information lacks materiality, meaning it has no discernible effect on decision-making, it is deemed irrelevant.

2) **Honest representation:** Honest representation, often referred to as reliability, underscores the alignment between reported numbers and descriptions with the actual state of affairs or events. This fidelity is crucial since most users lack the time or expertise to independently assess the accuracy of the information provided. Honest representation comprises three key characteristics [9]:

   a. **Completeness:** This characteristic mandates the inclusion of all pertinent information essential for providing a faithful representation of the financial position and performance of the entity. Omissions could result in inaccuracies or misinterpretations, rendering the financial information less useful to stakeholders.

   b. **Neutrality:** Neutrality dictates that financial reporting should remain impartial and unbiased, devoid of any partiality towards particular stakeholders or interests. This ensures that the information presented is objective and serves the needs of all users equitably.

   c. **Freedom from error:** This aspect pertains to the accuracy and reliability of the information provided. While the goal is to minimize errors to the extent possible, achieving absolute perfection may not always be feasible due to inherent uncertainties and the reliance on estimates in financial reporting. Nonetheless, efforts are made to ensure that financial statements offer a true and accurate representation of the entity's financial position and performance.

- *Secondary qualitative characteristics [1]*

1) **Comparability:** This characteristic refers to the consistency in the measurement and reporting of information across different banks, enabling users to identify similarities and differences in economic events among them. Comparable information facilitates meaningful comparisons, aiding users in assessing the relative performance and financial position of various banks.

2) **Understandability:** Decision makers possess varying levels of expertise, backgrounds, and information needs, necessitating that financial information be comprehensible to a diverse audience. Understandability ensures that users with reasonable knowledge can grasp the significance of the information presented. Clear and concise presentation enhances understanding and facilitates informed decision-making.

3) **Appropriate Timing:** Timeliness is crucial in financial reporting, as information must be available to decision makers in a timely manner to retain its relevance and influence decision-making effectively. Providing relevant information promptly enhances its usefulness and enables decision makers to act based on current insights. Delayed or untimely information

may diminish its impact on decision outcomes [10].

4) **Verifiability:** Verifiability refers to the ability to confirm the accuracy and reliability of reported information through independent verification processes. Independent measures conducted using consistent methods should yield similar results, enhancing the credibility and trustworthiness of the financial information. Verifiable information instills confidence in users regarding the accuracy and integrity of the reported data.

3.3. Factors affecting financial instruments and disclosure according to IFRS7

The discussion on financial instruments and disclosure often involves various factors that shape accounting practices and reporting standards. These factors, elucidated by Atallah [11], can be delineated as follows:

1) Factors related to legal, accounting, and financial legislation play a significant role in shaping accounting disclosure practices. Laws such as Income Tax Law No. (113) of 1982 and its subsequent amendments, as well as the Commercial Bookkeeping System for Income Tax Purposes No. (2) of 1985 and its amendments, influence the requirements and standards for financial reporting.
2) Factors pertaining to the bank itself are crucial in determining the extent of disclosure. These factors encompass various characteristics such as the size of the bank, the industry it operates in, the level of technological advancement within the organization, its age, and its profitability. These internal factors significantly impact the level and depth of disclosure undertaken by the bank.
3) Factors associated with the external auditor also influence accounting disclosure practices. External auditors are tasked with verifying the adherence of financial reports to generally accepted accounting principles. They may express concerns or opposition to extensive disclosure requirements that increase the scope of their audit responsibilities, particularly in areas involving non-traditional activities or complex auditing operations.
4) Factors related to the users of financial reports are paramount as their decisions hinge on the information provided therein. These parties include stakeholders who rely on the accuracy and reliability of financial information to make informed decisions. The level of awareness among users regarding the significance of the information, as well as their confidence and reliance on it, profoundly influences the demand for comprehensive and transparent disclosure practices [12].

3.4. Elements of accounting disclosure in financial statements

The notion of disclosure has evolved within accounting literature, transitioning from a safeguarding mechanism for the average investor against potential harm resulting from unfair practices to a more comprehensive approach. This involves simplifying disclosed accounting information to enhance accessibility for investors with limited expertise. Additionally, disclosure now extends to educational or media platforms, seeking to furnish information conducive to informed investment decision-making [13].

Indeed, furnishing information to aid decision-making among stakeholders stands as a primary objective of financial reports. This necessitates accurate disclosure of financial data and other pertinent information tailored to the needs of these stakeholders, statutory requirements, and the auditor's requisites for formulating an opinion. However, owing to the diverse parties benefiting from accounting information and their varying interests, defining disclosure becomes nuanced. Identifying the target audience and the purpose of the report is crucial, yet challenging, given the multifaceted nature of stakeholders' interests. Consequently, articulating a comprehensive definition of disclosure capable of satisfying the preferences of these parties proves intricate. Herein lies a summary of the key elements of accounting disclosure [14]:

1) Identify the users of accounting information: Accountants differ on the intended recipients of accounting information, ranging from economic planners, financial regulatory bodies, to individual investors with varying risk preferences. This divergence in audience personas impacts the nature of disclosure, tailored to cater to the informational needs and cultural literacy levels within each category [15].
2) Determine the volume and type of accounting information disclosed: Investors universally require essential accounting data to facilitate efficient capital market performance, enabling risk assessment for constructing diversified investment portfolios tailored to individual risk appetites.
3) Determine methods of accounting disclosure: Various disclosure methods exist, with the selection of the optimal approach contingent upon the nature of the accounting information. Emphasis is placed on presenting critical and relevant information prominently within one or more financial statements.
4) Determine the purpose of using accounting disclosure: Financial statements serve as the primary information source underpinning decision-making across all levels of the national economy. Given the diverse purposes served by accounting information, suitability is paramount, with information tailored to specific users or objectives [13].
5) Determine the timing of accounting disclosure: The timeliness of accounting information delivery is crucial for its relevance. Untimely information lacks utility in decision-making processes. The concept of appropriateness underscores the necessity of providing accounting information in a timeframe conducive to influencing decisions effectively. Sacrificing some precision in favor of timely delivery may prove beneficial in certain scenarios [2].

3.5. Purpose of using IFRS7 financial instruments – disclosures

Both modern and traditional financial instruments serve as vehicles for buying or selling future risks and contribute to market liquidity. They also facilitate profit generation for investors in exchange for assuming calculated risks through financial strategies and innovative financial approaches. The primary objective of innovative financial instruments is to offer mechanisms for managing and mitigating various risks, which will be further categorized later on [16]. Innovative financial instruments offer opportunities to reduce transaction costs by allowing for the payment of a small margin for contractual purposes instead of the full contract amount upfront. Financial and banking institutions utilize these instruments as tools for risk management, enabling them to effectively mitigate risks associated with investment portfolios through hedging. This involves reducing the exposure to financial risks by taking offsetting positions in related assets or securities. Additionally, speculation entails entering into specific financial positions to capitalize on favorable price movements, while arbitrage allows institutions to profit from pricing imbalances in similar financial instruments without assuming significant risks. Arbitrage involves buying and selling financial instruments simultaneously in different markets to exploit pricing differentials [17]. Based on the definition provided by Spiceland et al. [16], financial instruments for presentation in a company's balance sheet are classified as follows:

1) Financial Assets:
   a. Cash: Represents physical currency and cash equivalents.
   b. Contracts giving the company the right to receive cash or another financial instrument, such as accounts receivable.
   c. Contracts giving the company the right to exchange financial instruments under favorable conditions, such as stock options.
   d. Ownership instruments of the company in another entity.
2) Financial Liabilities:
   a. Contracts imposing on the company an obligation to deliver cash or another

financial instrument to another entity, such as accounts payable.

b. Contracts imposing on the company an obligation to exchange financial instruments under unfavorable conditions, such as unfavorable stock options.

These classifications enable a clear delineation of financial assets and liabilities in the balance sheet, providing stakeholders with valuable insights into the company's financial position and obligations [16].

The company holds a contractual obligation that offers flexibility in settlement options, allowing for either the utilization of financial assets or the surrender of capital components, such as capital bonds. If the quantity of capital bonds necessary to fulfill the obligation varies with their fair value fluctuations, resulting in total fair value alterations, gains or losses may ensue due to these price changes, treating such fluctuations as financial obligations on the entity.

According to International Accounting Standard (32), fair value denotes the amount at which an asset can be exchanged or a liability can be settled between knowledgeable and willing parties in an equitable transaction.

An ownership instrument refers to any contract establishing residual rights in a company's assets after deducting all its liabilities. Additionally, with regards to cash financial assets and cash financial liabilities, often termed as cash financial instruments, they represent financial assets and liabilities to be received or paid in the form of a specific or determinable amount of currency.

According to this classification, financial instruments encompass both basic financial instruments like receivables, payables, and stocks, as well as innovative (derivative) financial instruments such as financial options, futures contracts, interest rate swaps, and currency swaps, whether they are recorded or not in the books (recognized or unrecognized). Assets in kind, such as inventory, property, machinery and equipment, leased assets, and intangible assets like patents and trademarks, are not considered financial assets. Although ownership or control of these assets presents opportunities to generate cash flows or other assets, it does not entail immediate rights to receive cash or other financial assets (International Accounting Standard 32 - Section 11). Common non-cash current assets include investments in other companies' shares, inventory, and prepaid expenses. These items possess general characteristics that distinguish them from cash assets. Short-term investments in ordinary shares are akin to cash investments, as they can be readily converted into cash when needed for current operations. However, converting inventory into cash necessitates selling it during marketing operations and subsequently collecting accounts receivable. Prepaid expenses, on the other hand, cannot be directly converted into cash, as the company obtains benefits in exchange for them and utilizes them in operations, without representing rights to receive cash or a financial asset [18].

Similarly, certain items, such as deferred revenues and the majority of guarantee liabilities, are not classified as financial liabilities because they are settled through the provision of goods and services rather than cash or any other financial asset. The definition of financial assets and financial liabilities encompasses contingent rights and contingent liabilities, even though many of these assets and liabilities may not meet the criteria for recognition in the financial statements [19]. The ability to exercise a contractual right or fulfill a contractual obligation may be either absolute or probabilistic, contingent upon the occurrence of a future event. For instance, a financial guarantee represents a contractual right for the lender to receive cash from the guarantor, while concurrently constituting an obligation for the guarantor to provide cash to the lender in the event of the borrower's default. Although the legal rights and obligations arise from a past event (the guarantor's pledge), the exercise of these rights and the performance of obligations are contingent upon a future event or action, such as the borrower's failure to make payments. Liabilities or assets that lack a contractual basis, such as income taxes imposed by governmental tax laws, are not classified as financial liabilities or financial assets

(International Accounting Standard (32) paragraph 11-12-13).

As outlined in the Thirty-Ninth International Accounting Standard, four categories of financial assets are mandated, as detailed in the tenth paragraph [20]:

1) **Assets or liabilities held for trading:** These are assets or liabilities held primarily for profit generation from short-term price fluctuations or dealing margins, excluding loans and receivables. For derivative financial assets and liabilities not designated as hedging instruments, they are considered financial instruments held for trading.
2) **Investments held to maturity:** These are financial assets with fixed payments due, which the company has the intent and ability to hold until maturity, excluding loans and receivables originated by the company.
3) **Loans and receivables originated by the company:** These are financial assets created by providing money, goods, or services to customers, excluding those created for immediate sale, classified as assets held for trading. Loans and receivables originated by the company do not include held-to-maturity investments, which are classified separately under this standard.
4) **Financial assets available for sale:** These are financial assets that do not fall under loans and receivables originated by the company or investments held until maturity, nor are they financial assets held for trading. They are not considered available for sale if they are part of a portfolio with a trading style aimed at profiting from short-term price fluctuations or dealing margins.

Accountants typically refrain from offsetting current assets against current liabilities on a company's balance sheet. Even if specific assets are designated to cover certain liabilities, both are recorded separately on the balance sheet. The mere intention to use particular resources does not warrant offsetting, except in limited cases dictated by specific circumstances [18]. International Accounting Standard (IAS) 32 permits offsetting financial assets and financial liabilities, allowing companies to present the net amount on the balance sheet, as outlined in paragraph 33 of the standard. This entails offsetting between any financial asset and financial liability, with the resulting net value reported on the balance sheet under certain conditions [19]:

1) If the company possesses a legally binding right to set off or settle the realized amounts, offsetting between financial assets and financial liabilities is permitted. For instance, if a company has both a debit account and a credit account with the same entity, offsetting may occur. However, offsetting is not permissible if there is a negotiable payment note due to Company A, unless an unconditional agreement exists for such offsetting.
2) Offset is also allowed if the company intends to apply the right to settlement on a net basis or simultaneously prove the asset while settling the claim.

This right grants the debtor the authority to offset part or all of the amount owed to the creditor by offsetting a corresponding amount owed to the debtor by the creditor, or by offsetting their debt with a third party, provided there are arrangements in place among all parties permitting such settlement. However, if the debtor possesses the right to offset but does not intend to settle on a net basis or fails to prove the asset while simultaneously paying the required amount, disclosure of the impact of this right on the credit risks is necessary. Mere intention to settle without a legal right to do so does not suffice for offsetting, as the rights and obligations pertaining to both the financial asset and the financial liability remain unchanged. Settlement of two financial instruments can occur through clearing houses or informal markets simultaneously, resulting in equivalent cash flows and eliminating liquidity or credit risks. Alternatively, settlement may involve receiving and paying separate amounts, exposing the company to credit risks concerning the entire asset value or liquidity risks related to the liability value. Therefore, simultaneous realization of a financial asset and settlement of a financial liability is only applicable when both processes occur simultaneously.

4. Conclusion

The study has unequivocally demonstrated the critical importance of several disclosure practices in enhancing the transparency and reliability of fair value measurement in financial reporting. Specifically, the findings underscore the necessity of disclosing the selling value of assets previously considered unreliable in fair value measurement. By providing clarity on the selling value, stakeholders can better understand the basis for valuation decisions and assess the reliability of reported values.

Moreover, the study highlights the significance of disclosing the recognized gain or loss amount associated with fair value measurements. This disclosure enables stakeholders to gauge the financial impact of valuation changes and assess the overall performance and financial health of the entity.

Additionally, the research emphasizes the importance of providing comprehensive reasons for reclassifying a financial asset to amortized cost instead of fair value. Such disclosures offer insights into the rationale behind accounting policy changes and help stakeholders evaluate the appropriateness and consistency of valuation methodologies.

In summary, the study underscores the critical role of transparent disclosure practices in promoting trust, accountability, and informed decision-making in financial reporting. These findings have significant implications for regulators, standard setters, and practitioners seeking to enhance the reliability and credibility of fair value measurements in financial statements.

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