HOW TO ACCOUNT FOR BONDS WITH PAYMENTS IN DIFFERENT CURRENCIES

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SUMMARY

In the article, the authors consider one of the requirements of the new standard for financial instruments - the definition of the direction of payments to repay the principal and interest on current debts. The authors note that the standard does not provide for clear instructions regarding bonds, thus one has to judge them independently. The authors believe that this is precisely the reason for the existence of various approaches. In addition, the authors classify financial assets according to the business model used to manage them.

Keywords: standard for financial instruments, payment orientation, contractual payments, bonds.

One of the requirements of the new standard for financial instruments is to determine that payments under the contract are aimed at paying off the principal and interest on current debts. But in relation to bonds, the standard does not give clear instructions, especially if payments on them are provided in different currencies. Judgment will have to independently - these are the arguments to different approaches. Financial assets are classified based on the business model used to manage them and their characteristics associated with the contractual cash flows. In order to classify a financial asset as recorded at amortized cost or at fair value through other comprehensive income, the contractual terms of the financial asset must determine whether cash flows are received on the fixed dates for the principal amount and interest on the unpaid part of the principal amount.

But how to determine whether this condition is met if payments on a financial asset are expressed in different currencies? To better understand, what the problem is, consider an example.

Suppose the organization "A" has issued bonds. The nominal amount of bonds issued is 10 million Japanese yen. Circulation period is five years. Interest on bonds is fixed and paid in dollars annually. The principal debt (10 million Japanese yen) is paid after five years in Japanese yen.

The question is - can such bonds be considered a financial asset whose contractual terms determine the receipt of cash flows on the dates indicated?

To answer this question, you need to refer to clauses B4.1.1 – B4.1.26 (IFRS) 9. In particular, it saysნ that “the organization should assess whether the contractual cash flows are solely payments to the principal amount of the debt and interest for the outstanding part of the principal amount as applied to the currency in which the financial asset is expressed.”

In what currency financial assets (bonds) are expressed in this example? Most importantly, how to find out whether the cash flows on such bonds are in line with the standard?

Recently, the International Financial Reporting Standards Advisory Committee decided not to include this item on the agenda. Therefore, if you come across the need to account for such or a similar instrument, the accounting procedure will have to be determined independently.

There are the following opinions and arguments.

Opinion 1. Bonds do not correspond exclusively to payments on account of the principal amount of the debt and interest on the outstanding part of the debt. It is necessary to check for compliance with the criterion of the bond as a whole, based on the currency in which the nominal value of the bond is expressed. A bond with payments in two currencies is a single instrument that cannot be divided into components to check for compliance with the IPO criterion.

In the example, the nominal value of a bond is expressed in Japanese yen. Therefore, in order for such a bond to meet the IPO criterion, all cash flows on it must be in Japanese yen. Since fluctuations in the Japanese yen-dollar exchange rate create exposure to risk that is not related to the underlying loan ratios, such bonds do not meet the IPO criterion.

This opinion is consistent with paragraphs BC4.196–204 of the grounds for conclusions to the International Financial Reporting Standards (IFRS) 9: the standard requires that a hybrid contract in which a financial asset acts as the main contract is not divided into components, but is classified and assessed as a whole. Therefore, the requirements of clause B4.1.8 of the International Financial Reporting Standards (IFRS) 9 apply to a bond as a single instrument. And for such a bond to meet the IPO criterion, all cash flows on it must be in one currency (in which the nominal value of the bond is expressed).

Proponents of this approach believe that the main reason why the phrase “in relation to the currency in which a financial asset is expressed” is included in paragraph B4.1.8 of the IFRS 9 is the need to resolve issues of accounting for bonds in different currencies that differ from the currency in which the nominal value is expressed.

Opinion 2. Bonds correspond exclusively to payments on account of the principal amount of the debt and interest on the outstanding portion of the debt. Proponents of this opinion are confident that the verification of compliance with the IPO criterion should be carried out with respect to the two components of the bond. Since the interest rate on bonds is fixed, the cash flows on the bonds can be divided into two components, each of which is expressed in its own currency:

- cash flow on principal, denominated in Japanese yen;

• interest rates denominated in dollars.

In their opinion, if you prove that each of the components meets the IPO criterion, then the bond as a whole also meets the IPO criterion. They recognize that it is necessary to check for compliance with the IPO criterion in relation to the currency in which the financial asset is expressed (clause B.4.1.8 IFRS 9). They believe that in cases when the instrument provides cash flows in two currencies and can be broken into two components, each such component should be tested for compliance with the IPO criterion for the currency in which the cash flows of this component are expressed. This separation is consistent with the example presented in Tool C of clause B4.1.13 of the IFRS 9, which contains a similar explanation related to accounting for a variable interest rate instrument with a built-in cap.

EXAMPLE

Tool C (clause B4.1.13, IFRS 9)

Instrument C is a bond with a stated maturity date and variable market interest rate. This variable interest rate has a fixed maximum (“cap”).

The contractual cash flows, both for a fixed interest instrument and a variable interest instrument, are solely payments on the principal amount and interest on the outstanding part of the principal amount, provided that the interest reflects repayment of the time value of money, credit risk associated with the instrument over its life and other normal risks and costs associated with lending, as well as profit margins (paragraph B4.1.7A, IFRS 9).

Accordingly, a tool that combines fixed and variable interest rates (for example, a bond with a fixed maximum (“cap”) interest rate) may have cash flows that are solely payments on the principal amount of the debt and interest on the outstanding part of the principal amount.

Such a contractual condition can reduce the volatility of cash flows by imposing restrictions on a variable interest rate (for example, setting a fixed maximum (“cap”) or minimum (“flore”) interest rate) or increase the volatility of cash flows as the fixed rate becomes variable.

As for the discussion in paragraphs BC4.196–204 of the Grounds for conclusions to IFRS 9, advocates of opinion 2 conclude from it that the components of the instrument should not be taken into account separately and the entire instrument should be a single object of accounting. And since this discussion does not say how to check the instrument for compliance with the IPO criterion, it should be considered that the entire instrument meets the IPO criterion if it complies with both components. Otherwise, the instrument should be classified as fair value through profit or loss.

Proponents of Opinion 2 believe that when checking bonds with flows in different currencies for compliance with the IPO criterion, it is necessary to take into account the influence of the terms of issue of these bonds on changes in the cash flow schedule and their values.

In particular, you need to take into account:

- variable interest payments expressed in one currency and based on the face value in another currency cannot comply with clause B4.1.8, IFRS 9;
- terms of issuance that allow or require payment before maturity (for example, the creditor’s right to demand immediate redemption of bonds in the event of default) must be evaluated in accordance with paragraph B4.1.11, IFRS 9 and, if necessary, with paragraph B4.1.12 IFRS 9 . Conditions that allow or require early payment at face value (plus accrued interest) do not meet the IPO criterion (clause B4.1.11, IFRS 9). After all, the amount of early payment may not be approximately equal to the sum of the two identified components. The difference may vary depending on fluctuations in the rate.

Therefore, if you encounter the need to take into account such a tool, the reasons given will help you develop a correct approach.

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