

S02.04-SP-02-2

Financial Instruments: General principles

2. Recognition

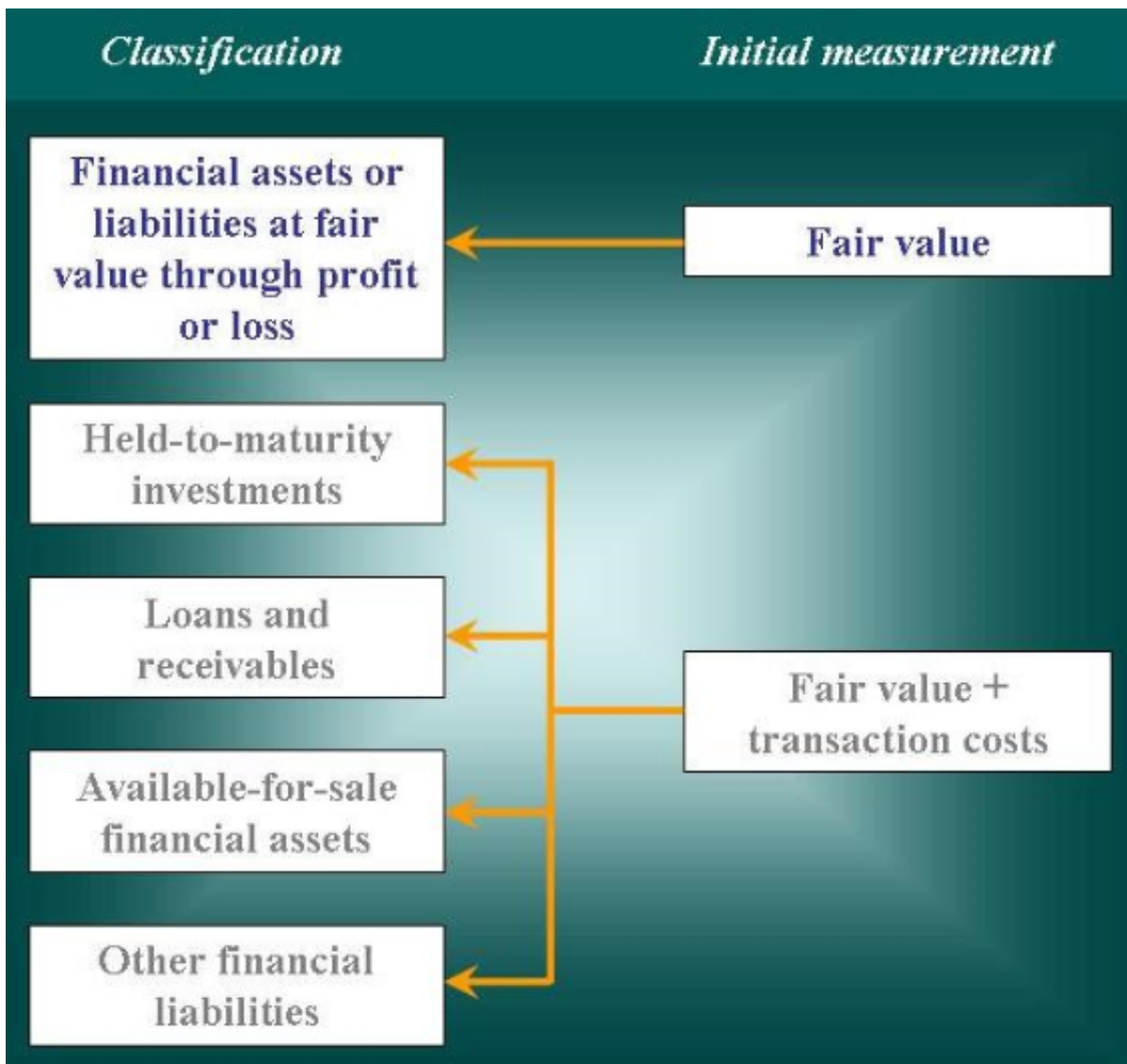
2.1. Initial recognition

The term "initial recognition" refers to the time at which an entity should record an asset or liability initially on its balance sheet. An entity should recognize a financial asset or financial liability when the entity becomes a party to the contractual provisions of the instrument.

In other words, financial assets or liabilities should be recognized when the entity becomes a party to the contract rather than when the transaction is settled.

See also the notes to the consolidated financial statements related to:

- [20. Financial assets](#)
- [21. Financial liabilities](#)



However, if loan assets or liabilities are issued at below the market interest rate, then the fair value on recognition is not the amount paid but the amount discounted for the effect of the below-market-value interest on the loans.

2.1.1. Financial assets:

- At the date it enters the balance sheet, the financial asset is measured at its **fair value plus issue expenses** except for assets at fair value through profit or loss. In most cases, the fair value of a financial asset corresponds to its purchase cost (trading value).

- **Balance sheet entry value (except for financial assets at fair value through P&L) = Fair value + Transaction costs**

2.1.2. Financial liabilities:

- In practice, financial liabilities are recognized upon **cashing in** of the principal or receipt of the principal in a bank account, since at this date the company has a present obligation to repay the borrowed principal in the future. The signing of the contract does not trigger the recognition of the funds to be received. Nevertheless, this creates a financial commitment that must be disclosed in the notes.
- At the date it enters the balance sheet, the financial liability must be initially recognized at its **fair value less transaction costs** that are directly attributable to the acquisition or issue of the financial liability. In general, at the outset, the fair value of the financial liability will be the cash received from the lenders upon issue of the liability.
- **Balance sheet entry value (except for financial liabilities at fair value through P&L) = Fair value - Transaction costs = Cash received**
- In most cases, the fair value of a financial liability corresponds to its cost (trading value). Thus a debt issued with a nominal value of 100 EUR issued at 99% with issue expenses of 1%, repayable at 105% will be recognized under IFRS as a balance sheet liability of 98 EUR offsetting the net cash received.

Debit	Bank	98	
Credit	Financial debts		98

Liabilities with deferred payment

The fair value is the value of the cash flows owed, discounted using an interest rate on the date of the transaction for the repayment period (the interest rate that enables the discounting of the nominal amount to the present cash purchase price). The fair value based on the discounting principle only applies for liabilities with deferred payment (in general for a period that exceeds 12 months or the normal operating cycle).

In the latter case, the difference stemming from the discounting must be recognized as interest income over the period in which the liability is paid.

In practice, the discounting mechanism will only be employed for at least a 50 kEUR bill.

2.1.3. Special cases of financial assets and liabilities that are not remunerated or have buydown rates

Loans that are not remunerated or have buydown rates, as well as non-current operating receivables and liabilities (> 1 year), must be analysed and possibly restated.

The standard (*IAS 39, Application Guidance AG79*) states that:

(...) Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

Initially, the money paid in return for financial assets and liabilities that are not remunerated or have buydown rates must be recognized in 2 separate components:

- The fair value of the loan or receivable (repayment flow discounted using a discount rate that reflects the company's usual borrowing rate);
- A subsidy granted by the lender (that will represent the difference between the cash received and the fair value of the loan or receivable at issue) the treatment of which in income must be assessed.

2.2. Subsequent measurement

Subsequent to initial recognition, financial assets and financial liabilities are **measured at fair value, amortized cost or cost depending on their classification and whether their fair value can be determined reliably.**

The subsequent measurement of financial instruments (*IAS 39, par 46*) and the accounting treatment of the gain or loss are summarized in the following table:

<i>Classification</i>	<i>Subsequent measurement</i>	<i>Gain/loss treatment: recognized in</i>
- Financial assets or liabilities at fair value through P&L	<i>At fair value</i>	P&L
- Held-to-maturity investments - Loans and receivables - Other financial liabilities	<i>At amortized cost</i>	P&L
- Available-for-sale financial assets	<i>At fair value for quoted financial assets</i> <i>At cost for unquoted financial assets</i>	Equity (OCI)

2.2.1. Fair value

- For **instruments quoted on an active market**, the fair value corresponds to the market price.
- For **instruments that are not quoted on an active market**, the fair value is determined by using measurement methods including reference to recent arm's length transactions or trading in substantially similar instruments, or the analysis of discounted cash flows employing to the extent possible assumptions that are consistent with market realities. Nevertheless, where it is impossible to reasonably estimate the fair value of an equity instrument, the latter is kept at **historical cost**.

Fair value determination sequence for financial assets or liabilities at fair value through P&L and quoted available-for-sale financial assets:



2.2.2. Amortized cost

- **Held-to-maturity investments, loans and receivables, and other financial liabilities are subsequently measured at amortized cost using the effective interest rate method .**
- Under the effective interest rate, the amortized cost is the cost adjusted by the cumulative amortization of the premium or discount (i.e. the difference between the purchase price and the maturity amount) through the expected life of the financial instrument. Any difference between the issue amount and the amount of the liability to be repaid, called the premium, must be included in the calculation of the effective rate.

Example of the application of the amortized cost method:

The effective interest method is most easily applied to instruments that have fixed payments and a fixed term. The following example illustrates this.

At the end of year Y, a company purchases a debt instrument with 5 years remaining to maturity for its fair value of EUR 1000 (including transaction costs). The instrument has a principal amount of EUR 1250 and carries a fixed interest of 4.72% payable annually (EUR 1250 x 4.72% = EUR 59 per year).

In order to allocate interest receipts and the initial discount over the term of the instrument at a constant rate on the carrying amount, it can be shown that interest needs to be accrued at the rate of 10% annually.

The table below provides information about the amortized cost, interest income, and cash flows of the debt instrument in each reporting period.

- Principal borrowed: 1250 EUR
- Annual interest rate: 4,72%
- Annual interest income: 59 EUR
- Net cash received: 1000 EUR

Year	(a) Amortized cost at beginning of year	(b) Effective interest rate	(c = a*b) Interest income	(d) Cash flows		(e = a+c-d) Amortized cost at year-end
				Interest	Principal	
Y						1000
Y+1	1000	10%	100	59		1041
Y+2	1041	10%	104	59		1086
Y+3	1086	10%	109	59		1136
Y+4	1136	10%	114	59		1190
Y+5	1190	10%	119	59	1250	0

See also: [Methodology applied in respect of the effective rate method](#)

2.2.3. Change in estimate with regard to the flows on the debt (known as "cumulative catch up method")

(IAS 39, Application Guidance AG8)

If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows.

The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss.

2.2.4. Foreign currency denominated financial liabilities

*Foreign currency denominated financial liabilities are translated at the **historical rate at the date of the transaction**.*

The application of the effective interest rate method is done on the basis of the foreign currency denominated cash flows.

*At each closing, the amortized cost of the foreign currency debt is translated at the **closing rate**. The resulting translation gains or losses are directly recognized in income (except where the foreign currency debt is classified as a net investment in a foreign operation).*

See also the note to the consolidation financial statements related to **8. Foreign currencies**

2.2.5. Distinction between financial debt and equity