

## FINANCIAL INSTRUMENTS ACCOUNT SETUP

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### Annotation

The process for identifying financial instruments in corporate entities, accounting for them, identifying their components, and representing them in financial statements are all stated in the piece of writing.

In recent years, financial instruments' complexity and diversity have increased significantly on global financial markets. Practical issues with accounting for financial instruments make the widespread adoption of international standards desirable.

The subject of financial instruments is regarded as the most challenging in the system of international standards of financial reporting.

Large-scale work is being done in Uzbekistan to make the transition to international standards of financial reporting. According to the decision of the President of the Republic of Uzbekistan dated February 24, 2020 No. PQ-4611 "On Additional Measures for the Transition to International Standards of Financial Reporting," the transition to these standards will be accelerated, and the necessary information will be made available to foreign investors and helps to strengthen the system of educating accounting and auditing experts in accordance with international standards and to increase access to international financial markets.

### Key words

Contract, financial asset, financial liability, equity, debt, bond, preferred stock, private equity, forward, futures, SWAP.

**Introduction.** Intensive work is being done in Uzbekistan to make the shift to international standards of financial reporting. The President of the Republic of Uzbekistan issued Decision No. PQ-4611 "On Additional Measures for the Transition to International Standards of Financial Reporting" on February 24, 2020, accelerating the transition to international standards of financial reporting and providing foreign investors with the necessary information and it provides an unambiguous explanation of the problems with increasing access to global financial markets, enhancing the system for educating accounting and auditing professionals

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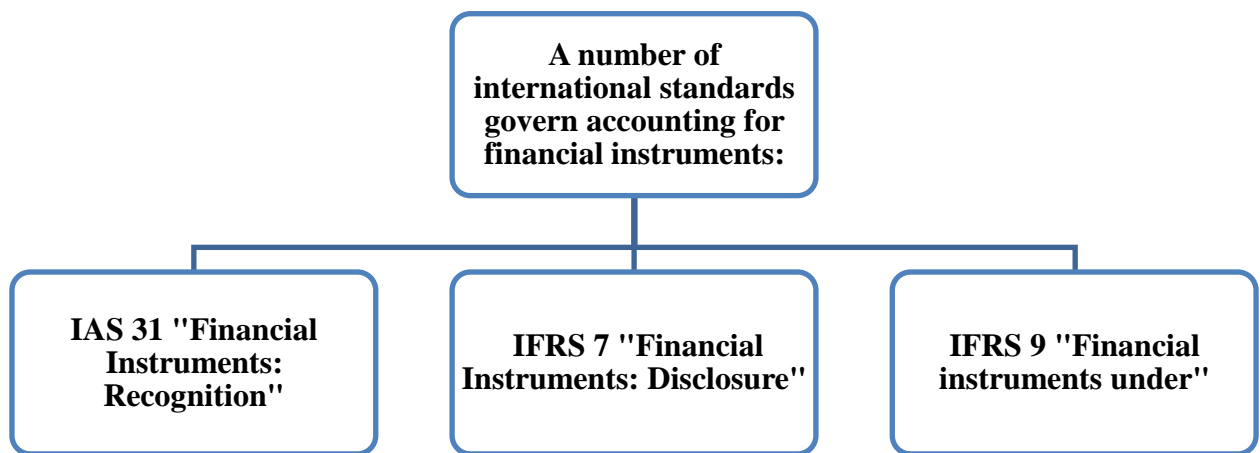
in accordance with global norms. Additionally, this decision establishes an exemption from filing a financial report for commercial banks, joint-stock companies, insurance organizations, and legal entities included in the category of large tax payers that voluntarily prepare financial reports in accordance with international standards based on the organization of accounting on the basis of international standards of financial reporting and national standards of accounting beginning on January 1, 2021. To argue that this procedure was one of the key phases in our nation's transformation to worldwide standards would be an exaggeration.

Ideas were considered to expand cooperation with non-governmental educational organizations (International Association of Certified Certified Accountants - ASSA) and others for retraining and professional development in the field of accounting and auditing in order to popularize the successful experiences the world has had in training specialists in this field. Every financial transaction in our nation must be implemented with a document proving that the subject "Financial reporting according to international standards of financial reporting" was successfully completed. This document must also include the certificates "Certified Diploma Accountant (ASSA)" and "Diploma in International Financial Reporting (DipIFR)," which guarantee the participation of accountants with one is.

**Methodology.** The comparison, analysis and synthesis, induction and deduction, grouping, and analytical methodologies are widely used throughout the work.

**Results.** In recent years, financial instruments' complexity and diversity have increased significantly on global financial markets. Practical issues with accounting for financial instruments make the widespread adoption of international standards desirable.

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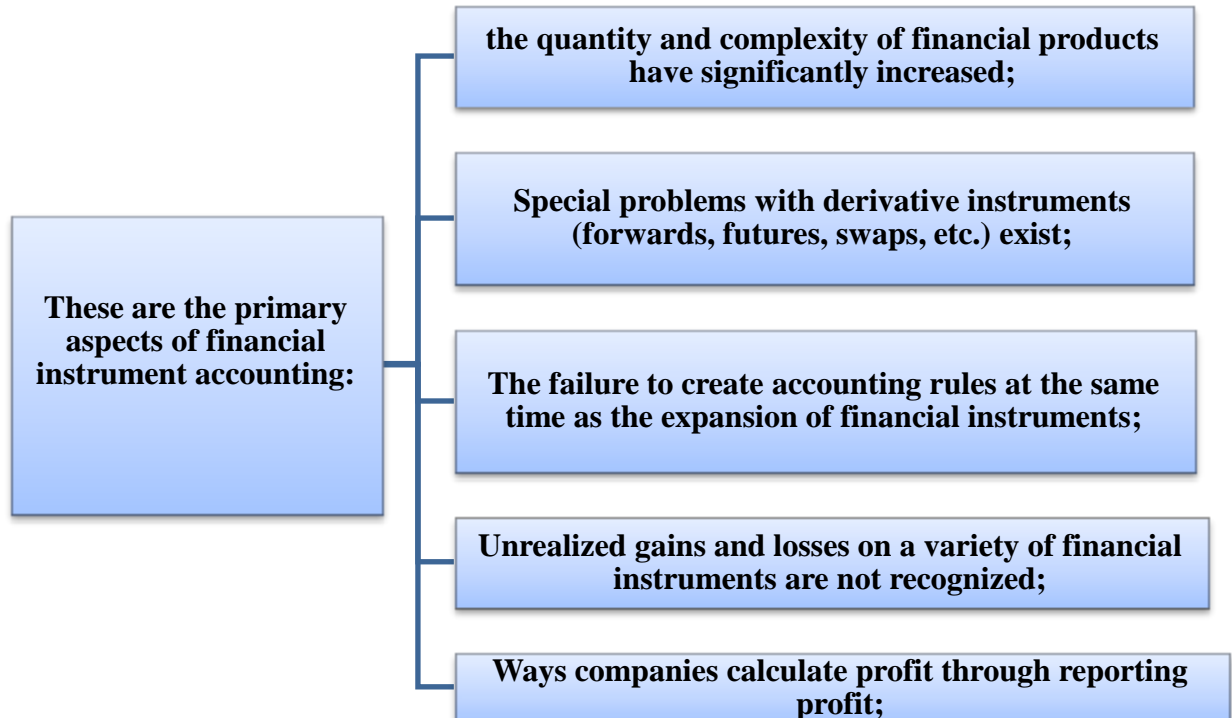


**Figure1. International standards for accounting for financial instruments.<sup>2</sup>**

IAS 32 is concerned with how financial instruments are categorized and presented in financial statements.

IFRS 9 is concerned with the accounting for and presentation of financial instruments.

IFRS 7 is concerned with the financial instrument disclosure in financial statements.



**Figure 2. Features of accounting for financial instruments.<sup>3</sup>**

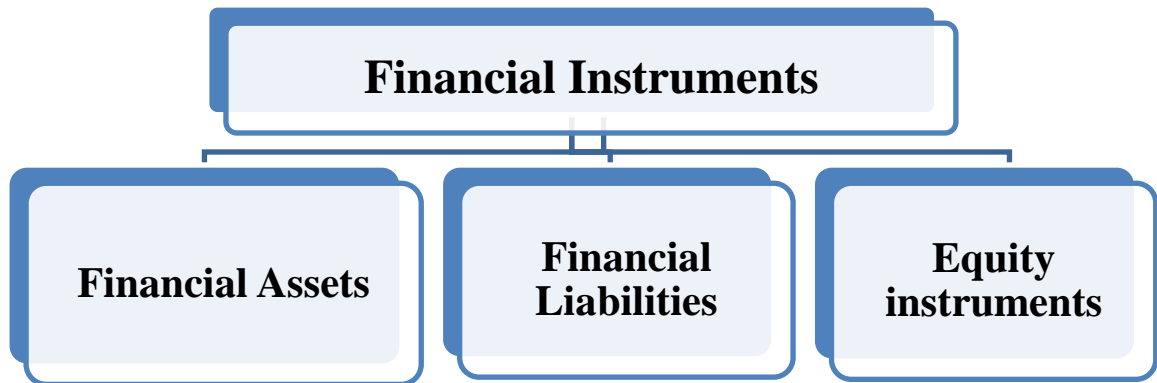
<sup>2</sup> Developed by the authors

<sup>3</sup> Developed by the authors

The definition of financial instruments may be found below based on the previous data.

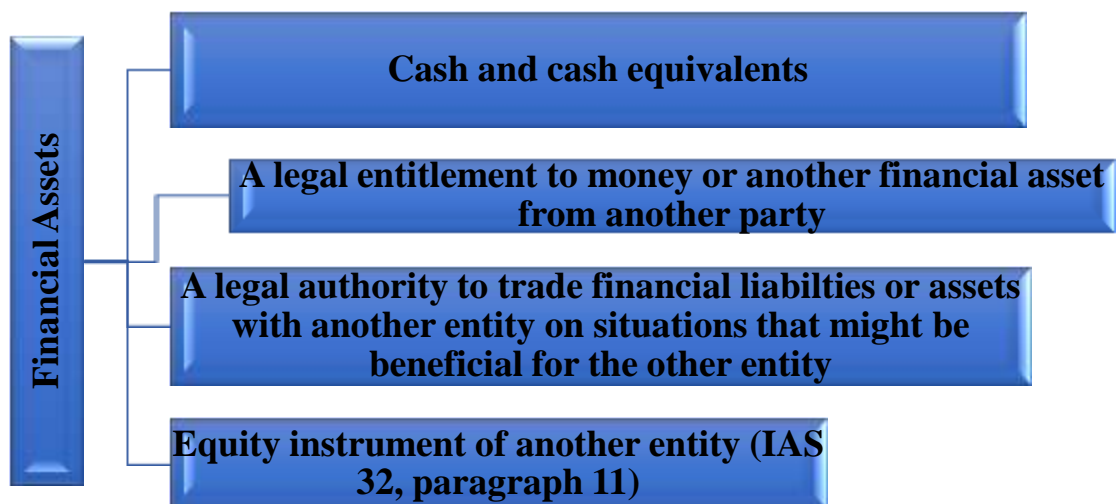
*A financial instrument is a contract that is a financial debt or equity instrument in one company and a financial asset in another.*

This means that the structural makeup of financial instruments will be as follows (Figure 3).



**Figure 3. The structure of Financial Instruments.<sup>4</sup>**

Figure 4 below illustrates the components of the financial assets.

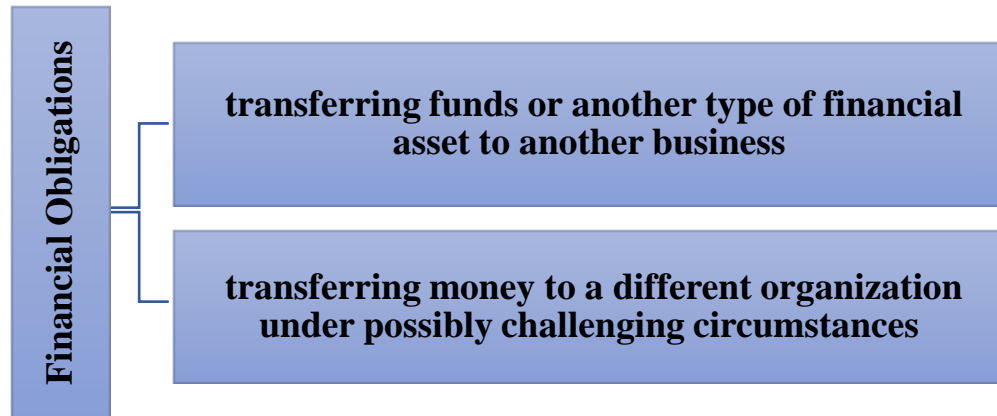


**Figure 4. Definition of Financial Assets<sup>5</sup>**

The structure of financial obligations are shown in Figure 5

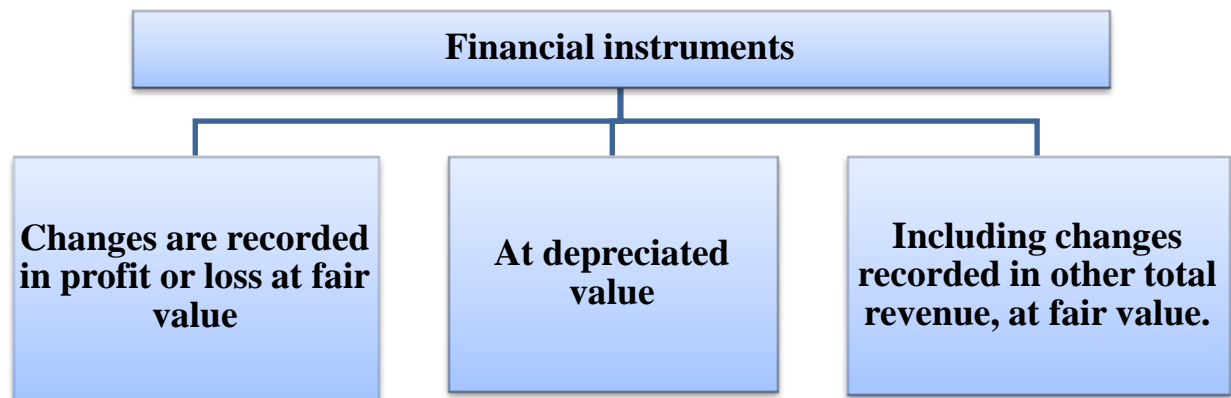
<sup>4</sup> Developed by the authors

<sup>5</sup> Developed by the authors



**Figure 5. The components of financial obligations.<sup>6</sup>**

**Equity instruments-** a written agreement stating the owner's claim to a portion of the company's assets, such as common stock.



**Figure 6. The accounting models of Financial instruments.<sup>7</sup>**

**By profit or loss, financial instruments are recognized at fair value. The next two stages are taken into consideration:**

- Test of the business model. It depends on why the investment is being made.
- Examining the features of the contract's cash flows. It examines the nature of the cash flows from an investment.

**Accounting for financial instruments using amortized cost:**

- Test of the business model. The business must intend to keep the investment until it matures.
- Examining the features of the contract's cash flows. The financial asset must provide cash flows that exclusively represent principle and interest payments on the outstanding balance in order to comply with the contract's requirements.

If the debt instrument is carried at amortized cost, interest income (calculated at the effective rate of the liability) is recorded in the income statement, and the

<sup>6</sup> Developed by the authors

<sup>7</sup> Developed by the authors

year-end value of the asset is computed in the same manner using the amortized cost.

**It serves two purposes for financial instruments to be valued fairly through other comprehensive income.**

- Test your business model. The business must aim to keep the investment until it matures, but it may sell the asset if a chance to buy another, more lucrative asset presents itself.

- Examining the features of the contract's cash flows. According to the contract, the financial asset must provide cash flows that simply represent principle and interest payments on the outstanding balance, just like when amortized expenses are accounted for.

Financial obligations are first valued at fair market value. The conventional method for determining it is to take the net amount received and minus the expenses incurred to issue the obligation.

Estimation of financial obligations afterwards Financial obligations are documented at the cost of amortized.

**Depreciation cost is calculated as follows:**

**Nominal value + interest calculated at the effective rate - interest paid.**

If there are other expenses associated with the loan, such as repayment fees, issuing fees, or discounts, the interest computed at the effective rate is different from the interest paid. A deep discount bond is an illustration of this type of obligation.

The deep discount bond is one of the most popular forms of financial securities.

*Such a tool is sold for a substantial amount less than what it would normally cost*

*The coupon rate is typically substantially lower than the market rate.*

*The total value of the loans includes::*

- - *emission costs;*
- - *discount on issue;*
- - *annual interest payments;*
- - *premium on payment.*

The net revenues from the offering represent the bonds' original value.

A constant periodic interest rate is computed by calculating the total financing costs during the instrument's lifetime.



The internal rate of return and the constant periodic interest rate (also known as the effective rate) are both computed using the same formula. The exam includes the effective interest rate.

These bonds are calculated at amortized cost, much like the majority of financial obligations.

**Nominal value + interest calculated at the effective rate - interest paid**

**Take note how their value evolves while the bonds are in circulation.** A \$1,000 worth of bonds were released by Alpha Enterprise. For \$1,250, the bonds may be sold. The bonds have a five-year duration and a 5.9% yearly interest rate. 10% is the actual interest rate.

Financial obligations have to be valued at their amortized cost.

Initial recognition for bonds is \$1,000. The sum of the required loan payments and the proceeds of \$1,000, or \$545, is the total cost of borrowing (\$1,545 (5 x \$59 interest + \$1,250 down payment

Following are changes in the balance sheet value of debt instruments during the course of their validity period:

Year	Balance at the beginning of the year	Financial expenses for the year (10%)	Expenses paid during the year	Balance at the end of the year
1	1 000	100	- 59	1 041
2	1 041	104	- 59	1 086
3	1 086	109	- 59	1 136
4	1 136	113	- 59	1 190
5	1 190	119	(1.250 + 59)	-
		545		

- The figures at the end of each year are an estimate of the amortized cost that should be shown in the statement of financial condition.

- The amount of debt on the balance sheet (also known as the amortized value) is determined by deducting payments from the financial costs shown in the financial statement.

### **Preference shares**

If the non-redeemable preference shares are not subject to any capital or dividend obligations, they are regarded as a part of equity.

Preferred shares are viewed as a financial obligation if they are redeemable or offer set cumulative dividends.

As a result, the main standard is that if there is a payment requirement, an instrument qualifies as an obligation.

Preference shares that are not redeemable fall under the category of equity. If the preferred shares are subject to mandatory repurchase at a fixed or determinable price at a fixed or determinable future date specified by the issuer, or if their holders have the right to demand that the issuer repurchase the shares on or after a fixed or fixed price at a fixed or fixed price, and should be recognized as such, then the instrument meets the definition of a financial liability.

### **Interests and Dividends**

The method of accounting for fixed assets determines the method of accounting for interest and dividends:

- Dividends on instruments categorized as liabilities are considered as financial costs in the statement of profit or loss;
- Declared dividends on shares are directly recorded in equity.

Alfa Company issued 100,000 redeemable preferred shares on April 1, 2021, each having a \$1 par value and an 8%-of-par coupon rate. They get a sizable premium in exchange for their services, which results in an annual financial charge of 12%.

**When preparing the financial statements for the fiscal years ending March31, 2022 and 2023, we shall take into consideration how these redeemable preferred shares will be recorded.**

It is first important to locate the yearly cost here.

Annual payment:  $\$100,000 \times 1 \times 8\% = \$8,000$

The following table is then used to base the account.

Yea	Balance at the inning of the	Financial expenses the year (12%)	Expenses paid ng the year	Balance at the of the year
1	100 000	12 000	- 8 000	104 000
2	104 000	12 480	- 8 000	108 480

As of March 31, 2022 and 2023, the information in the table has the following effects on the statement of financial position and the statement of profit or loss:

<b>The statement of financial position</b>		
Long-term liabilities:	2023	2022
Preferred Stock	108 480	104 000

<b>The statement of profit or loss</b>		
Expenses	2023	2022
	-12 480	-12 000

**Sorting as a liability or equity**



A financial instrument's substance might be different from its legal structure. Some financial products have the legal appearance of equity but are really liabilities. Others could blend aspects of obligation and self.

The existence of a contractual obligation on the part of one party (the issuer) to provide cash or another financial instrument to another party (the owner) or to exchange another financial asset or liability, as well as the existence of such a contractual obligation, are the main characteristics that set financial liabilities apart from equity instruments. When, regardless of how it is settled, the instrument satisfies the criteria of a financial responsibility.

The issuer is nonetheless responsible for the obligation and the holder's rights under the instrument even if there are limitations on their capacity to pay, including a lack of access to foreign currency or the requirement to acquire regulatory clearance for payment.

An equity instrument is a type of financial instrument that does not produce such a contractual obligation. Although the owner of an equity instrument is entitled to a portion of any dividends or other distributions of profits made by the issuer, the issuer is not obligated by contract to make such payments and cannot be legally forced to declare dividends.

**A compound financial instrument** is a financial instrument that has the characteristics of both debt and equity instruments (such as convertible bonds).

The convertible loan has the following characteristics:

- the lender agrees to an interest rate below the market rate for non-convertible securities;
- the amount of shares to be issued is established;
- the lender agrees to an interest rate below the market rate for non-convertible securities.

Such convertible instruments are accounted for by components, i.e., equity and debt components are recognized separately, since the lender offers the firm a reduced rate of return in exchange for the chance to obtain equity stake:

- has an equity component because investors may decide to convert the loan into equity;
- includes a liability or debt component because the issuer may be forced to repay cash.

Convertible loan accounting is divided into two phases: initial recognition and subsequent measurement.

### **Initial recognition**

The liability shall be measured at its fair value. Fair value is the present value of future cash flows (interest and principal) discounted at the market interest rate

for non-convertible debt instruments. The amount of money that is drawn from the debt element shall form part of the equity component.

A subsequent valuation shall be made at the amortized cost of the liability.

**Actual cost + interest at market rate - interest paid**

As long as the debt is not repaid, the equity component is not overvalued, that is, its value in the statement of financial position is unchanged.

**Convertible notes**

The company's issuing bonds and debt instruments that can be converted into shares.

- In view of that the conversion terms are often very favorable, bondholders may purchase company shares at a discount. The offer could still be attractive even when the shareholders choose to sell their shares. A bondholder in need of funding at maturity will convert into shares and sell them on the stock exchange for a profit.

- In return for that potential return, bondholders must pay an interest rate that's typically lower than the market rate and have to wait for some time before they receive the shares that generate most of their income. There is also a risk that the company's stock performance makes the conversion unappealing.

- A complicated financial instrument should be broken down into components:
  - financial responsibility component (debt component);
  - equity component (potential conversion into shares);

These components should be separately disclosed in the financial statements.

A convertible loan of \$5 million was issued by Alpha Enterprise on Jan 1, 2020. The loan pays 2% annual interest at the year-end. The loan can be fully repaid or converted to shares after 3 years. If market interest rate is 8% for such unsecured debt instruments. Discount factors (discount coefficient) 1 year: 0.926 2 years: 0.857 3 years: 0.794 respectively.

Discount factors are found using the following formula:

$$D = \frac{1}{(1+\Phi)^n}$$

Here  $\Phi$ - market interest rate, n-year.

Year	The amount paid at the end of year	Discount coefficient	Current value
1	100 000	0,926	92 600
2	100 000	0,857	85 700
3	5 100 000	0,794	4 049 400
<b>Borrowed capital</b>			4 227 700
<b>Share</b>			772 300
<b>Received money</b>			5 000 000

Alpha Enterprise has approved this process as following:

Dt Cash and cash equivalents \$5,000,000

Kt Financial obligation \$4,227,700

Kt Equities \$772,300

The financial expenses are determined by Alpha enterprise using the account book.

Year	Remaining at the beginning of the year	Discount coefficient 8%	2% interest payment at the end of each year	Remaining at the end of the year
1	4 227 700	338 216	- 100 000	4 465 916
2	4 465 916	357 273	- 100 000	4 723 189
3	4 723 189	377 855	- 100 000	5 000 000

Alpha Company's income statement for 3 years.

Year	2022	2021	2020 ил
Financial expenses	377 855	357 273	338 216

The report on the financial position of the enterprise Alfa presents the following indicators for 3 years

Year	2022	2021	2020
Capital component	772 300	772 300	772 300
Long-term liabilities	-	4 723 189	4 465 916
Short-term liabilities	5 000 000	-	-

**Financial assets: Initial recognition of financial assets**

While recognizing and measuring financial assets, this is regulated by IFRS 9.

“An enterprise shall only recognize a financial asset or financial liability in its statement of financial position when it meets the requirements of this standard” IFRS9, clause 3.1-1.

At the time of initial recognition, financial assets are determined at fair value.

This can be the amount of money paid to purchase a financial asset.

Transaction costs are included in the cost of the asset unless the asset is measured at fair value through profit or loss.

**Stock tools**

Equity instruments (shares purchased from other companies) are taken into account:

- at fair value with changes recognized in profit or loss;
- at fair value with variations recognized in other comprehensive income.

**At fair value with changes recognized in profit or loss**

This is the standard type for accounting for equity instruments.

Transaction costs of these instruments are not included in cost at initial recognition but are considered expenses.

Then, at the end of each year, the initial value of the asset is restated and the gain or loss is reflected in the income statement.

**At fair value with changes recognized in other comprehensive income**

Equity instruments may be accounted for at fair value by other comprehensive income instead of at fair value by profit or loss. The selection of this accounting approach should be made at the time the financial asset becomes available, but only if the investment is expected to be a long-term one. The choice is final, that is, future accounting adjustments to fair value can't be made with adjustments reported at profit or loss.

At fair value, with adjustments to reflect profit or loss in the following cases:

- Transaction costs are capitalized;
- The investment is revalued to fair value on each reporting date; and The gain or loss on the investment is recognized as a gain or loss in the other comprehensive income, and then recognized as a loss on equity in the form of an investment reserve.

This method of revaluation is similar to that of PPE (Property, Plant and Equipment) under IAS 16, except that in this instance, the investment reserve may be negative.

**Stock tools (extra information)**

Generally, equity instruments are carried at fair value through other comprehensive income, and fair value is the price paid for them. This may include unquoted equity investments whose fair value at each reporting date is difficult to measure reliably. However, IFRS9 does not provide a general exception for unquoted equity investments to be accounted for at cost. Instead, it provides guidance on whether or not standard cost is a reliable measure of fair value.

An equity instrument can be accounted for at fair value with changes recognized in other comprehensive income if the conditions specified in the standard are met, namely:

- the equity instrument cannot be held for trading;

- this accounting method is selected upon initial recognition and cannot be changed later.

### **Conclusion and Suggestions.**

1. A financial instrument is a contract that represents a financial asset on the one hand and a financial liability or capital instrument on the other hand.
2. A financial instrument is basically a contract between two parties. It's made up of cash and cash equivalents, a contract to get cash or other financial assets from another company, a contract to trade financial assets or liabilities with another company on terms that could be good for the company, and equity interests in another company.
3. Financial obligations are also part of a financial instrument.
4. Financial instruments are valued based on their current market value, considering the cash flow they will generate at the coupon (interest) rate. The fair value of the instruments is determined based on the effective interest rate.
5. Actual expenses incurred are added to financial assets, and such expenses are deducted from financial liabilities.
6. Financial instruments are accounted for under three models. Examples: Fair value through profit or loss, amortized cost, fair value through other comprehensive income, and fair value through profit or loss models are common.

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