



## REVIEW

# How to Recognize and Measure Compound Financial Instruments?

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### ABSTRACT

Basing on the Xiaomi case, this paper discusses the most appropriate accounting treatment of compound financial instruments under the framework of *International Financial Reporting Standards (IFRS)* and how other comprehensive income (OCI) plays important role in it. Overall, this paper provides some references for policymaker to standardize financial instruments standard.

## 1. Introduction

In June 2018, as soon as the prospectus of Xiaomi was disclosed by China Securities Regulatory Commission, Xiaomi's "puzzling" financial statement

triggered heated discussions. According to *International Financial Reporting Standards (IFRS)*, in 2017, Xiaomi lost 43.9 billion-yuan RMB. But if Xiaomi didn't apply IFRS, it would profit 5.4 billion-yuan RMB. The difference between the two is 49.3 billion-yuan RMB, of

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which only convertible redeemable preferred shares can increase profit by 54.1 billion-yuan RMB. And if exclude the influence of convertible redeemable preferred shares, Xiaomi's owners' equity can change from negative 127.2 billion-yuan RMB to positive 34.3 billion-yuan RMB. So what is Xiaomi's real financial situation? Is a serious loss or a high profit? Is it insolvent or powerful?

The essential question is the accounting treatment of compound financial instruments. When measuring convertible redeemable preferred shares, Xiaomi indicated that because it didn't meet the "fixed-to-fixed" standard of *International Accounting Standard No. 32 (IAS32)* and the credit risk of the liability led to little fair value changes, it was recognized as financial liabilities which were measured at fair value and fair value changes were included in profit and loss. According to the principle of prudence, Xiaomi divided its convertible redeemable preferred shares into financial liabilities. But this debt has neither legal significance nor economic essence, it's only a pure theoretical virtual debt. And it eventually triggered "puzzling" financial statement problems and reduced accounting information quality.

There are three approaches to improve the accounting information quality of compound financial instruments: (1) including fair value changes into OCI; (2) introducing "mezzanine equity" items; (3) recognizing the value of debt component and equity component separately. Among three approaches above, the first has stronger operability and the lowest cost. The second has greater advantages in understandability and impact on financial statement. The third has weak operability and strict constraints. Under the framework of IFRS, the first approach is the most preferable one. Accordingly, this paper focuses on the first approach.

## 2. The Most Appropriate Accounting Method of Compound Financial Instruments

About the initial recognition of financial instruments, for compound financial instruments with dual attributes of liability and equity, it has always recognized as financial liabilities or equity instruments integrally. Under the ideology of "minimization of equity", since the recognition of equity instruments needs to meet the "fixed-to-fixed" standard, most enterprise recognizes them as financial liabilities in practice. However, it will lead to a situation that "the more profit the enterprise makes, the more loss it confirms", which is contrary to business logic. In fact, we can adopt another thought – "maximization of equity" to relax the conditions for the recognition of equity instruments, not only restricted to "fixed-to-fixed" standard.

In terms of the subsequent measurement of financial instruments, throughout the financial instrument standards, the fair value changes are either included in profit and loss or OCI. From Xiaomi case, we can see that the former has huge impacts on profit indicators, and there will be a puzzling phenomenon of "the higher the valuation of enterprises, the more serious the loss". *IFRS No.9 - Financial Instruments* points out that OCI should be used to reflect the fair value changes caused by the credit risk of financial liabilities of enterprises themselves. The revised Accounting Standards for Business Enterprises No. 22 - *Recognition and Measurement of Financial Instruments*, which is promulgated by Chinese Ministry of Finance in March 2017, stipulates that financial asset should use fair value through OCI (FVTOCI) to measure if its holding purpose includes both contract cash flow and sale.

An enterprise's income includes core income and transitory income.<sup>[1]</sup> OCI arises from random walk processes and should be zero in expectation, thus belongs to transitory income.<sup>[2-3]</sup> According to a recent study, earnings-price-ratio is the most effective measure of firm value in China.<sup>[4]</sup> OCI has value relevance, is correlated with stock price.<sup>[5-6]</sup> Thus, although OCI should be transitory in nature, it also can favor investors to make decisions. That's means, if use FVTOCI to recognize and measure compound financial instruments, the accounting information quality also improved. Taken together, we can consider expanding the scope of OCI appropriately to allow the fair value changes caused by earnings expectations and non-tradable equity valuation, that is measure the investment at FVTOCI.<sup>[7]</sup> For the compound financial instrument that both for contractual cash flow and sale, FVTOCI can not only alleviate the illogical points mentioned above, but also reflect the large fluctuation of owner's equity when the amount of fair value changes is huge.

## 3. Summary and Conclusions

Xiaomi's "puzzling" financial statement have led us to reconsider the most appropriate accounting treatment of compound financial instruments. Under the framework of IFRS, this paper provides two solutions: The first is based on the concept of "maximization of equity", relaxing the conditions for recognizing financial instruments as equity instruments. The second is for financial instruments that both receive contractual cash flows and for sale, using FVTOCI to measure. OCI is closely related to the accounting treatment of financial assets. In the face of increasingly complex capital market and financial innovation, it is a good way to use OCI when dealing with complicated compound financial instruments. The application of OCI's mixed accounting measurement attributes

not only improves the accounting information quality and useful for investors to make decision, but also reflect the integration of asset-liability view and income-expense view.<sup>[8]</sup> Overall, this paper provides some suggestions and references to policymakers on how to improve financial instruments standard.

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