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Short Term Financial Instruments: Meaning, Types, Risks, and More

Financial instruments a.k.a money-making tools function as engines of the worldwide economy. They can represent both an asset and a contract that carries monetary value and can be traded within the financial markets. The breadth that is covered in this definition is extremely wide, as it captures a large coverage of product categories (including equities, bonds, derivatives and bank deposits). Such instruments are employed by organisations, individual investors and financial institutions for the purpose of investing, risk management and raising capital. What are Financial Instruments?Financial instruments are the financial tools which an individual and business use to manage their money and all related risks. In this article, we are going to explain financial instruments in detail, covering types of instruments, the risk, and practical applications in various sectors of finance.

What are Financial Instruments?

Financial instruments can be defined as contracts between parties arising out of the value of money. They are, therefore, obtainable assets such as stocks and bonds and contracts such as derivatives. Such tools help businesses and individuals invest their money, hedge against risks, and earn profit. There are different categories of financial instruments in finance, each of which serves a specific role in the economy.An investor would be able to make an informed and a wise decision if he/she knows about the various types of financial instruments and their examples.

Definition of Financial Instruments

Legal rights to receive financial value under a financial contract are considered to be financial assets. Such instruments can be a contract such as money or securities that may be traded, transferred or even used to hedge against financial risk. Economics can use financial instruments to provide very fruitful economies for businesses and individuals alike in creation, borrowing, and financial planning.

Short Term Financial Instruments

Short-term financial instruments refers to tools or securities used by companies, banks or investors to manage money for a short period — generally less than one year. They are liquid, meaning they can easily be bought and sold without losing value. They help businesses with day-to-day cash needs, short-term goals and immediate expenses.

These instruments are considered low-risk since they have short maturities. Which also means the money you invest circulates a bit and again comes back to you with a little percentage of interest or profit. These are typically utilized by businesses to assist with working capital and by investors seeking a safe place to temporarily park their cash.

Types of Short Term Financial Instruments

Treasury Bills (T-Bills)

These are factoring instruments and applicable for government. The government sells them at a discount and when they mature, the investor gets the full face value. Maturity value — Cost price = Profit

- **Tenor**: 561 days, 561 days or 364 days
- **Issued** by: Central government
- **Risk:** Lowered (backed by government)

T-bills are some of the safest places to park short-term money. Such are preferred by investors as there is no default risk.

Commercial Paper

Commercial paper is an unsecured, short-term debt instrument issued by a corporation to finance its short-term credit needs. These documents are usually sold at a loss and require no collateral.

- **Maturity**: Up to 364 days
- **Type**: High-grade corporates
- **Risk**: Medium (risk to community will depend on the solvency of the company)

This is one of the reasons businesses prefer commercial paper: it is cheaper and faster than a normal bank loan.

Certificates of Deposit (CDs)

Market Linked Debentures: A class of time deposit offered by the banks. Essentially, you spend an amount of money for a given amount of time and receive interest on it. It is safe (and better than a savings account).

- **Maturity**: seven days to one year (for short-term CDs)
- **Issued by:** Commercial banks
- **Risk:** Low

CDs make sense for investors that are trying to earn higher returns on dead money, but without taking on a ton of risk.

Repurchase Agreements (Repos)

Repurchase agreements are essentially short-term loans, where one party sells securities to another and agrees to repurchase them later at a higher price. The difference between these is the interest.

- **TIME**: Overnight to a few weeks
- **Risk**: Low to moderate

Repos are mostly used by banks to manage their daily cash and to meet reserve requirements.

Banker's Acceptances

A banker's acceptance is a time draft that is backed by a bank. (For a business to get paid for goods, and guaranteed by the bank to payment in the future. These are not rare events in global trade.

- **Maturity**: 30 to 180 days
- **Who uses it**:Exporters and importers
- **Low** (bank guarantees payment): risk

Financial Instruments and Their Usage

In accounting and finance, the term financial instruments may be used in many different contexts. These include;

- **Consideration:** If you do see a downturn in the market, you're less likely to see a depreciation in your assets.
- **Risk Management:** Derivatives insulate market price shocks from their sudden moves..
- **Liquidity Management:** Bank deposits and monetary instruments fund businesses and individuals.

- **Capital Raising**: Companies raise Money through stock and bond issuance by companies to create funds for expansion.
- **Foreign Exchange**: Forex instruments are instruments through which a business and individual can manage currency risk.

Risk in Financial Instruments

Financial instruments have different risks according to the types and uses attached to them. Some offer steady returns, while others swing with abrupt changes. Risk in financial instruments comes from the generalities in the movements of the market, as well as economic conditions and the risk profile of the issuers. Some of the common risks are as follows:

- **MarkeRisk**- the prices of stocks, bonds, and derivatives differ due to economic and political forces.
- **Credit Risk** - Generally, bonds and loans have a default risk as it relies on the fact that the issuing party has settled the entire payment.
- **Liquidity Risk- f**inancial instruments may not sell quickly in the market.
- **Currency risk** changes in price due to the currency adjustments would lead foreign exchange instruments to have exposure.
- **Interest Rate Risk** changes in both rates influence the prices of bonds and other fixed-income instruments.

Any investor analyses the risk of a financial instrument before indulging in investment decisions, as returns are usually higher with higher risks.

Classification of Financial Instruments

The risk in financial instruments is one of the things that each investor and finance professional needs to know themselves because it is the foundation of all analysis of the risk and return for any financial instrument.

Accounting Classification

From an accounting perspective, financial instruments are categorized by the type of financial instruments and basis of use; the accounting categorization relates to:

- Assets, which include Cash, Stocks, Bonds and Receivables;
- Financial Liabilities — loans, bonds, and other obligations;
- An Equity Instrument is an ownership interest in a corporation including common and preferred shares.
- These financial instruments are recognized and accounted for by companies in their financial statements according to International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP).

Bank Financial Instruments

These financial instruments help the banking sector raise, lend and invest money. The banks are involved in:

- **Lending**: The bank offers loans, credit lines, and mortgages whereby people and institutions borrow money.
- **Investment:** Banks invest in bonds, stocks, and derivatives for returns.

- **Liquidity Management:** Certificates of deposits and treasury bills are issued by banks to meet their cash flow needs.
- **Foreign Exchange**: The banks trade currencies to facilitate international transactions.

Financial Instruments Market

Instruments are traded in the market that is on exchanges and over-the-counter (OTC) platforms. Crucial types of Markets are:

- **Stock Market-** It is a venue where buy, sell and trades of public companies.
- **Bond Market-** This market covers the issuanceand trading of government and corporatedebt, which is known as the bond market.
- **The foreign exchange market** (forex) is the place where currencies are traded.
- **Derivatives Market:**– Place where futures, possibilities and swaps trade.

Investment and Economic Impact

The one of the main purpose towards global economy is providing investment channel and liquidity for the funds in exchange for for investment products which are designed in financial instruments markets.

Investment of Financial Instruments

You're trained to buy and sell for people, corporations gleaning riches. Before that, when we start talking about financial instruments, the conversation is always in terms of national economies, jobs and the distribution of wealth.

- Investment uses the instruments of financial markets to gain a return. Investing is based on the risk omaind and requirements of an individual or company. Here are a few investment strategies:
- Additionally, the Investment you chooseLong Term Investment- Returns on stocks, bonds and mutual funds are generated in IT over time.
- High-issue Investment- The Forex, choices, and futures proffer the opportunity of fast gains but is also plagued with high risk.
- Retiring Planning- Fixed deposits, pension funds, and government bonds are constructed to guarantee a secure future.

Financial Instruments in Economy

Financial instruments have their impact either directly or indirectly on economic growth and financial stability. One way or another, they help with:

- **Capital Formation**- Corporations begin selling stocks and bonds to raise money for expanding their business.
- **Funded:** creation of jobs in investment - "Investment and risk management."
- **Monetary Policy Implements** — A government financial instrument to control inflation & hence interest rates.

Relevance to ACCA Syllabus

Breakdown of Financial Instruments is a key area in Financial Reporting (FR), in Strategic Business Reporting (SBR) and in Advanced Financial Management (AFM), and it features prominently in the ACCA syllabus. Financial instruments are also paramount in the preparation of IFRS-based financial statements, strategic risk management, and investment decisions. International Financial Reporting

Standard (IFRS) 9 relates to recognition, measurement, impairment and hedge accounting of Financial Instruments. Financial instruments constitute a considerable portion of the ACCA syllabus, equipping its students with essential skills and knowledge for assessing financial performance, handling business risks, and maintaining adherence to worldwide financial reporting standards.

Short Term Financial Instrument ACCA Questions

Q1:Under IFRS 9, what are the classification categories for financial assets for measurement purposes?

A) Amortised cost and fair value (FVTPL; FVOCI)

B) COGS can be measured at historical cost or replacement cost

C) Cash method, accrual method and hybrid method

D) Liability: Current, non-current and contingent liability

Ans: A) amortised cost fair Value through P&L fair Value through OCI

Q2: Which of the following financial instrument is an equity instrument under IFRS 9?

A) Convertible bonds have a debt aspect

B) Preference Shares Redeemable at will

C) Equity common stock with voting capability

D) Trade receivables

Ans: Issued common shares with voting rights

Q3: In respect of an impaired financial asset, what is the IFRS 9 model for measuring the expected credit loss?

A) Incurred Loss Model

B) Transition mechanisms (Model to calculate ECL)

C) Proportional Loss Model

D) Discounted Cash Flow Model

Ans:B) Transition mechanisms (Model to calculate ECL)

Q4: Where gains or losses on a financial instrument are recognised in other comprehensive income rather than profit or loss, this is permitted under the financial instrument measurement models within which of the following?

A) Amortized Cost

B) International Financial Reporting Standards (IFRS)

C) Fair Value Through Other Comprehensive Income (FVOCI)

D) Historical Cost

Ans: C) FVOCI (Fair Value through Other Comprehensive Income)

Q5: What is the primary purpose of hedge accounting?

A) Do aggressive financial ratio cleansing so they look good

B) Reducing volatility in the values of financial instruments markets in financial statements

C) Inflate profits through inflated asset prices

D) No tax on transactions.

Ans: B) To limit the effects of variances in market values of financial instruments in financial statements

Relevance to US CMA Syllabus

Financial instruments are provided in Part 2 (US CMA) in the study in the Financial Statement Analysis, Risk Management, and Investment Decisions. CMAs must understand how financial instruments impact a firm's total viability and risk profile." Knowledge of financial instruments also helps CMAs in treasury management, derivative valuation, hedging strategies, and in making managerial decisions, and investment decisions.

Short Term Financial Instruments CMA USA Questions

Q1: What is one of the most commonly used financial instruments that forward companies hedge foreign exchange risk with?

A) Bonds

B) Forward contracts

C) Bank overdrafts

D) Fixed deposits

Ans: B) Forward contracts

Q2: Why do we value assets at market?

A) By falsely boosting the financial statements

B) To identify the fairness of the value of financial instruments

C) To persist with historical cost accounting

D) To abide by taxation law compliance

Ans: B) In respect of fair value of financial instrument

Q3: A business agrees to swap fixed interest payments for floating interest payments. This is an example of:

A) Currency hedging

B) Interest rate hedging

C) Commodity hedging

D) Equity hedging

Ans: B) Interest rate hedging

Q4: What financial ratio will be impacted by this fair value revaluation of financial instruments?

A) Current Ratio

B) Quick Ratio

C) Return on Assets (ROA)

D) Earnings Per Share (EPS)

Ans : D) EPS (Earnings Per Share)

Q5 — How do we present financial instruments classified as trading securities on the balance sheet?

A) At historical cost

B) The valuation; gain/loss through profit or loss

C) At amortized cost

D) At book value

Ans: B) p/l – Fair value | p/l – gains/losses

Relevance to US CPA Syllabus

A large chunk of these financial instruments are covered in Financial Accounting and the Auditing papers in the CPA-USA (Certified Public Accountant) syllabus. US GAAP and IFRS have different approaches for classification and measurement of financial instruments, and this is an important item for CPAs to know as they prepare and audit financial statements. CPAs also evaluate the impact of financial instruments on an organization's financial position and risk management.

Short Term Financial Instrument US CPA Questions

Q1: Under U.S. GAAP, which financial instruments must be reported in the balance sheet at fair value?

A) a securities held to maturity

B) Investments at fair market value

C) Loans and receivables

D) Prepaid expenses

Ans: B) Available-for-sale securities

The 2nd Question: ASC 815 US CPA exam?

A) Business combinations

(B) Accounting for derivatives and hedging

C) Revenue recognition

D) Intangible assets

Ans: B) Derivatives and hedge accounting

Question 3: A corporation reclassifies a financial asset from "available for sale" to "held-to-maturity". How is this accounted for?

A) No change in the asset, fair value held with unrealized (gains/losses recognized.

B) The asset is then, thereafter measured at amortized cost

C) The entire asset is charged off

D) The company restates the net income

Ans: B) In future, the asset is measured at amortized cost

Q4: A recoverability test is performed to measure impairment of the financial assets in the US GAAP impairment model.

A) Expected credit loss model

B) Incurred loss model

C) Cash flow discounted method

D) Fair value method

Ans: A) Model of expected credit loss

Q5: What is a popular financial instrument that is used to hedge the stock market risk?

A) Options

B) Fixed deposits

C) Commercial papers

D) Government bonds

Ans: A) Options

Relevance to CFA Syllabus

Commercial derivatives fall under financial reporting and analysis, corporate finance, portfolio management, and many more in the CFA (Chartered Financial Analyst) syllabus. The CFA candidates are analyzing different financial instruments, how do you price them, and how do you manage risk? Financial instruments differ based on these factors, so discerning what these financial instruments are will help in stock picking and measuring risk in portfolio managing.

Short Term Financial Instruments CFA Questions

Q1: The following instrument has features of both debt and equity huh?

A) Common stock

B) Convertible bonds

C) Treasury bills

D) Mutual funds

Ans: B) Convertible bonds

Q2: One risk that will happen in bond pricing that you know the impact on bond price as a result of interst rate differences.

A) Credit risk

B) Liquidity risk

C) Interest rate risk

D) Inflation risk

Ans: C) Interest rate risk

Q3: In portfolio management, the Sharpe ratio is the ratio that measures

A) The rate of interest on risk free assets

B) The link between reward and risk taken

C) Company net profit margin

D) Fiscal rendering

Ans: B) Return per unit risk taken

Q4: Derivatives are recognized as follows under IFRS law:

A) Loans and receivables

B) Equity instruments

C — Financial instruments, at fair value

D) Long-term liabilities

Ans: C) Fair value through profit or loss (trading securities)

Q5: When valuing financial instruments, we use the Black-Scholes model.

A) Bond valuation

B) Option pricing

C) Real estate valuation

D) Equity valuation

Ans: B) Option pricing

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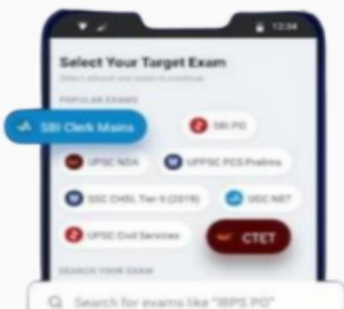

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