CHAPTER 24

Financial Instruments Ind AS 109, 32 & 107

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Dear friends,

This is a vast & highly challenging standard. You need to have lot of patience and consistency in reading this massive standard to understand better. **Every point of the standard is interlinked**, hence memorizing the subject is also very much necessary. Trust us, we tried to put it in better sequencing but still few points will be understandable only in second or third revision. Start this only after Revising basic concepts of time value of money;

- Types of derivatives such as options, futures, forwards, swaps, etc. (part of Strategic Financial Management) to understand this standard better;
- Revising definitions of "asset & liability" discussed in chapter "Framework for preparation of financial statements".
- You will be introduced to new concepts and new accounting terminology. This standard will be very helpful and necessary in your career.

For understanding few terms, we may introduce basics initially and later, the same will be discussed in detail. We suggest you to follow the same sequence as given in the book for better and logical flow of understanding.

Introduction

Before we start, I would like to ask you a question – Which Ind AS prescribes accounting treatment for debtors, cash, loans and advances, share capital, debentures, loans taken, trade payables and derivatives? (Think)

The answer is **NO** Standard that you learnt so far has covered these times because this standard (Ind AS 109) is going to cover all the above items. The coverage of this standard is extensive and hence, let us try to understand this standard to the extent required for examination.

As we discussed, this standard covers assets, liabilities and equity in its discussion.

Financial instrument topic is discussed in three standards

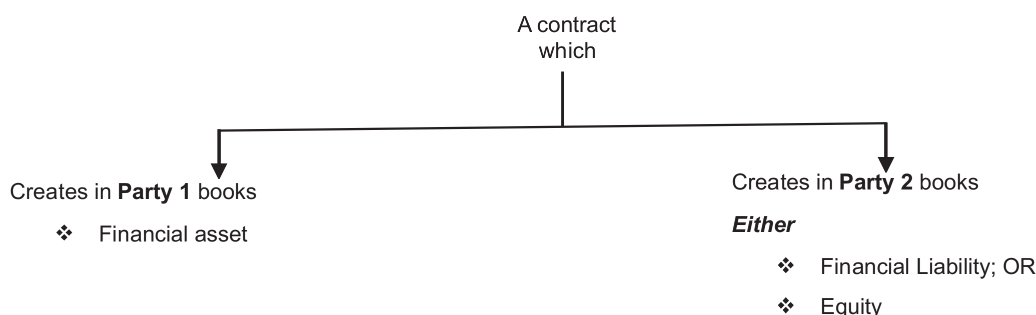
1. **Ind-AS 109 –** "Financial instruments" - discusses on
   - ❖ Recognition and Derecognition of financial assets and financial liabilities;
   - ❖ Classification of financial assets and financial liabilities;
   - ❖ Measurement of financial assets and financial liabilities; and
   - ❖ Hedge accounting.
2. **Ind-AS 32** discusses on "Financial instruments - **Presentation**"
   - ❖ Classification as Liability Vs Equity; and
   - ❖ Netting/offsetting of financial instruments; and
3. **Ind-AS 107** discusses on "Financial instruments - **Disclosures**".

Chalo, Let us start learning….

What is a "Financial Instrument"? (Read carefully)

Financial instrument is a **contract** that **gives rise** to a **financial asset** to **one entity** and a **financial liability/ equity instrument to another entity**.

As you know, there will be minimum two parties to the contract.



'Contract' and **'Contractual'** refer to

- ❖ An **agreement** between two or more parties;
- ❖ **Usually enforceable by law;**
- ❖ Contracts can be in writing or oral.

Actually, now you need to understand what is financial asset and financial liability. Well, before that let us try to understand the following examples of financial instruments

> ***Example 1:*** **A Ltd. sold goods to X Ltd.**
>
> In this case, sale of goods is a contract and A Ltd and X Ltd. are parties to this contract. As a result of this contract,
>
> - ➢ Financial asset (Trade receivable – a right to received money in the future) is created in the books of A Ltd.;
> - ➢ Financial liability (Trade payable – an obligation to pay money in the future) is created in the books of X Ltd.
>
> As the contract is creating financial asset in one party's books and financial liability in other party's books – it is a financial instrument.
>
> ***Example 2:*** **X Ltd. issued equity shares to Y Ltd.**
>
> In this case, acquisition of equity shares is a contract between X & Y Ltd.
>
> - ➢ An equity (Issue of equity shares) is created in the books of X Ltd.
> - ➢ A financial asset (Investment in equity shares) is created in the books of Y Ltd.;
>
> As the contract is creating financial asset in one party's books and equity in other party's books – it is a financial instrument.

Let us try to understand the meaning of financial asset, financial liability and equity in detail.

The following definitions are given in Ind AS 32.

Financial asset

A financial asset is any asset that is:

(a) cash;

Analysis: *Currency/Cash is a financial instrument because it is a medium of exchange of transactions and is therefore the basis on which all transactions are measured and recognized in the financial statements;*

*A **deposit of cash** with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the bank.*

(b) an equity instrument of another entity;

Analysis: *Investment in equity shares of other entity;*

Read the word carefully – It is "Equity" instrument not just 'equity share capital'. We will be discussing it below.

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

Examples: *Trade receivables, Bills receivables, loan and advance (given).*

In these cases, the entity has either a right to receive cash or other financial asset (i.e. equity instrument of any entity);

(ii) **to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity** *(Profit making);* or

Example: *A Ltd. holds a call option to purchase equity share in listed company X Ltd for ₹50 per share at the end of 60 days' period and if value of the share on exercise day is more than 50 Say 75 (This is called "In the money" in financial management terms). As you know, A Ltd. is called "Holder of the option" and X Ltd. is called "Writer of the option"*

As it is potentially favourable, it is a financial asset and A Ltd. recognises the same by debiting -Option asset & Crediting - Other income for ₹ 25.

Try to understand, when it is potentially favourable to A Ltd. , obviously it is the other side of the coin for X Ltd, i.e., potentially unfavourable to X Ltd and hence, it is an obligation to settle for X Ltd. Hence, it should recognise the financial liability by debiting - Expense/loss & Crediting - Financial liability for ₹ 25.

There is lot of discussion on these points in the following topics.

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) **a NON-DERIVATIVE for which the entity is or may be obliged to receive a variable number of the entity's OWN equity instruments; or**

E.g. *Sale of land and building by ITC Ltd. for ₹20 crore and the buyer should pay ₹20 crore worth of ITC Ltd. shares only on a particular date (But this may not be accepted by the law in India as it leads to buy -back of shares)*

(ii) **a DERIVATIVE that will or may be settled OTHER THAN by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments DO NOT INCLUDE**

- Puttable financial instruments classified as equity instruments,
- Instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the net assets of the entity only on liquidation and are classified as equity instruments; or
- Instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

Explained at later part of the chapter.

Important note:

As per the Companies Act, 2013 – a company cannot hold its own shares; hence Point (d) is not applicable in India. It leads to buy-back of shares and it should satisfy the provisions of the Companies Act, 2013.

Outside India, as per the laws of that country, a company can hold its own shares. Such shares are called

"Treasury stock" – Accounting of treasury stock is discussed in the later part to this chapter.

***Concept capsule 1* Perpetual debt Instrument**

A Ltd. issues a bond at principal amount of ₹1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8% applied to the principal amount of ₹ 1000. Assuming 8% to be the market rate of interest for the instrument when it was issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of ₹ 1,000 on initial recognition. Evaluate the financial instrument in the hands of both the holder and the issuer.

Suggested answer

- For the **Holder** – right to receive cash in future (Interest throughout the period and Principal at the time of liquidation) – classifies to be a **financial asset**;
- For the **Issuer** – Contractual obligation to pay cash in future – classifies to be a **financial liability**.

Some more questions are given at the end of equity definition

Financial liability (FL)

'Financial liability' is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

Examples: *Trade payables, Loan taken wherein the entity should settle by paying either cash or by transferring any other financial asset;*

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are **potentially unfavourable to the entity** (*loss making*); or

Example: *Refer the point in financial asset.*

(b) a contract that will or may be settled in the entity's own equity instruments and is

(i) a **NON-DERIVATIVE** for which the entity is or may be obliged to deliver a **variable number of the entity's own equity instruments;** or

E.g. A convertible debenture, which will be converted into equity shares based on the market value of the shares on the date of conversion. (Variable number of own shares – based on market value) (See below concept capsule)

(ii) A **DERIVATIVE** that will or may be settled for **OTHER THAN**

- By exchange of a **fixed amount of cash** (i.e. payable in variable amount is FL); or
- Another financial asset for a **fixed number of the entity's own equity instruments;**

Based on the above definition the following are NOT financial liabilities. They are equity instruments (read carefully)

✓ *For this purpose,* ***rights, options or warrants*** *to acquire a* ***fixed number*** *of the entity's own equity instruments* ***for a fixed amount*** *of any currency are* ***equity instruments*** *if the entity offers rights, options or warrants* pro rata *to all of* ***its existing owners*** *of the same class of its own* ***non-derivative equity*** *instruments. (Example: a contract to issue right shares, Share warrants, etc., are not financial liability).*

✓ *Apart from the aforesaid, **the equity conversion option embedded** in a **convertible bond denominated in foreign currency** to acquire a fixed number of the entity's own equity instruments **is an equity instrument** if the **exercise price is fixed in any currency**.*

In the above two cases – entity's own equity instruments do not include Puttable instruments (discussed part of "equity").

Concept capsule 2

A Ltd. (the 'Company') makes purchase of steel for its consumption in normal course of business. The purchase terms provide for payment of goods at 30 days credit and interest payable @ 12% p.a. for any delays beyond the credit period. Analyse the nature of this financial instrument for A Ltd.

Suggested answer

As per Ind AS 32, Financial liability is any liability which creates a contractual obligation to deliver cash or another financial asset to another entity.

In the given case, in the contract to purchase goods, A Ltd. has got an obligation to deliver fixed amount of cash to another entity. Hence, it is financial liability for the entity.

Concept capsule 3

A Ltd. (the 'Company') makes a borrowing for INR 10 lacs from RBC Bank, with bullet repayment of INR 10 lacs and an annual interest rate of 12% p.a. Now, Company defaults at the end of 5th year and consequently, a rescheduling of the payment schedule is made beginning 6th year onwards. The Company is required to pay INR 13 lakh at the end of 6th year for one time settlement, in lieu of defaults in payments made earlier.

(a) Does the above restructured instrument meet definition of financial liability? Please explain.

(b) Analyse the differential amount to be exchanged for one-time settlement.

Suggested answer

Please note that "bullet repayment" refers to lumpsum payment to be made for the entirety of an outstanding loan amount usually at the end of agreed tenure. That is, in case of a loan with bullet repayment, until the maturity date, only interest will be paid by the borrower to lender at agreed intervals and on maturity, both outstanding principal and interest will be paid.

As per Ind AS 32, Financial liability is any liability that is contractual obligation to **exchange financial assets or financial liabilities** with another entity under conditions that are **potentially unfavourable to the entity (loss making)**.

In the given case,

Loan principal amount = ₹ 10,00,000

Amount otherwise payable at the end of 6th year = Principal amount + two years' interest (i.e. 5th and 6th) at compound rate = 10,00,000 * 1.12 * 1.12 = ₹ 12,54,400

Cash payable as per understanding = ₹ 13 lakh;

Here, the company is exchanging the loan (settling the loan) by paying cash (cash is a financial asset) and the exchange is potentially unfavourable as it is paying excess amount i.e. ₹ 45,600 (₹ 13 lakh – ₹ 12,54,400); Hence, the rescheduled arrangement meets definition of 'financial liability'.

Concept capsule 4 (Settlement in variable number of shares)

Target Ltd. took a loan from Z Ltd. for ₹ 10,00,000. Z Ltd enters into an arrangement with Target Ltd. for settlement of the loan against issue of a certain number of equity shares of Target Ltd. whose value equals ₹ 10,00,000. For this purpose, fair value per share (to determine total number of equity shares to be issued) shall be **determined based on the market price of the shares of Target Ltd. at a future date**, upon settlement of the contract.

Evaluate this under definition of financial instrument.

Suggested answer

As per Ind AS 32, a financial liability a contract that will or may be settled in the entity's own equity instruments and is a NON-DERIVATIVE for which the entity is or may be obliged to **deliver a variable number** of the entity's **own equity** instruments;

In the given case, Target Ltd. has an obligation to settle by issuing variable number of its own equity shares worth of ₹ 10,00,000. Number of shares will vary based on the market value of share on the date of settlement. This contract is a non-derivative and thus, meets definition of **financial liability** in books of Target Ltd. *(Please note that in a derivative contract, the value (gain/loss) of the contract is often derived from changes in the value of an underlying asset and in this particular case, the contract is to obtain number of shares amounting to ₹10 Lacs and obviously it depends on the market price of the share itself and not any other asset price and hence, it is a non-derivative.)*

Equity instrument
(Revise financial liability once again before understanding this)

It is defined in two ways

Definition 1:

It is a contract that evidences a **residual interest** in the assets of an entity after deducting all of its liabilities;

It means equity instrument holder is the owner and who is ready to accept the remaining money after clearing all the liabilities of the entity. Remaining amount may be positive or nil.

Definition 2:

Equity instrument is the one which is **NOT a financial liability**. This is elaborated like this "*An instrument is equity instrument if it satisfies both of the following conditions* i.e. (a) and (b) *(read very carefully)*

a. The instrument includes **NO contractual obligation** to either (i) **to deliver cash or another financial asset** to another entity; or (ii) **to exchange** financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer;

b. If the instrument **will or may be settled** in the issuer's own equity instruments, it is:

   i. a non-derivative that includes **NO contractual obligation** for the issuer to deliver a variable number of its own equity instruments; or

   ii. a derivative that will be settled only by the issuer **exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments**.

To classify an instrument correctly whether as a liability or equity - One should NOT look at the nomenclature of the instrument BUT to observe the terms and conditions attached to it. *Follow the below discussion*

Preference shares

Think of this – Whether 'Preference shares' are to be classified as Liability or Equity?

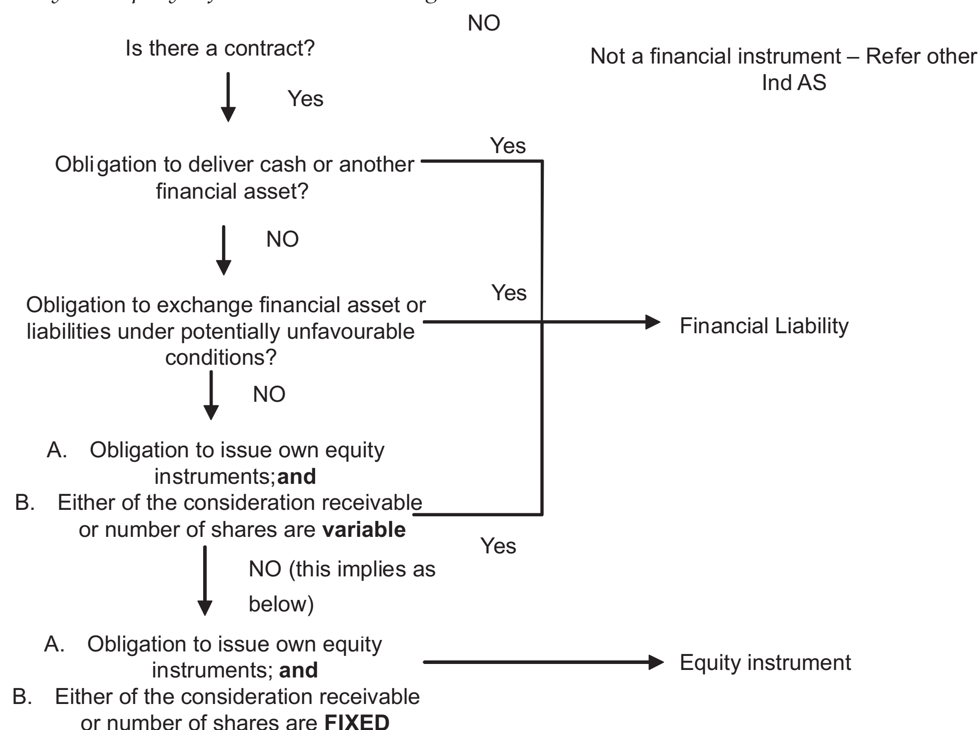
One cannot answer straight away without the terms and conditions to the contract.

Preference shares	
Redeemable ✓ at a specified date; ✓ at the option of the holder	In this case, the company has an obligation to settle by delivering cash or any other financial asset. It is a **Financial liability**; Irrespective of any reasons *like lack of funds, a statutory restriction or insufficient profits or reserves*, these are always treated at FL only.
✓ At the option of the Issuer (the Company)	❖ In this case, the company **does not have a present obligation** till the date it exercises the option i.e. decided to pay; Hence it should be classified as '**Equity'**. ❖ Whenever the issuer of the shares **exercises its option**, usually by **formally notifying the shareholders of an intention to redeem** the shares, at that time this instrument shall be reclassified as **'Financial liability'**. Think from the other hand i.e. from the point of view of the holder – the holder does not have right to claim for the amount. When NO ONE has right to claim, how come it is an obligation to the company and hence, classified as 'Equity'.
Non-redeemable preference shares (Irredeemable) This discussion is only for understanding the concept. As we know, that an Indian company cannot issue irredeemable preference shares.	*As you know*, in case of irredeemable preference shares, the principal amount is repayable only at the time of liquidation of the company and till then, the holders of preference shares do not have a right to ask the company to redeem. **But** For classification, one should consider other terms & conditions attached to the contract; ❖ If the distribution to the holders is at **the option of** the issuer (i.e. the company) – preference shares will be classified as 'Equity'; irrespective of whether the preference shares are cumulative or non-cumulative; We don't consider the following to classify it as equity: o History of dividend payment/intentions of payment; o Issuer's reserves balances; o Issuer's profit or loss for the period; o Non-payment effect on the company's equity shares, etc.
✓ **Preference dividend is at the discretion of the Issuer**;	It should be classified as **Equity.** *Think* It is akin to an equity instrument.
✓ **Preference dividends are cumulative – payable on liquidation**;	One need to check the contractual obligation as per the terms ❖ If NO contractual obligation to pay dividend on liquidation – Classify them as Equity; ❖ **If there is a contractual obligation to pay**: o **Present value of the dividend payable obligation** should be recognised as **'Financial liability';** o You will be understanding about this in detail at the topic of **"Initial recognition"**

Before getting into the questions, let us have comparative study

Financial liability	Equity
A financial instrument that fulfils **either of (A) or (B)** below:	A financial instrument that fulfils **both (A) and (B)** below:
Condition (A):	**Condition (A):**
An instrument that **is a contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.	An instrument that contains **NO contractual obligation**: i to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
Condition (B)	**Condition (B)**
An instrument that will or may be settled in the entity's own equity instruments and is:	An instrument that will or may be settled in the entity's own equity instruments and is:
i. a non-derivative for which the entity is or may **be obliged** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **other than** by the exchange of **a fixed amount of cash** or another financial asset for a **fixed number of the entity's own equity** instruments.	i. a non-derivative that includes **no contractual obligation** for the issuer to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **only by the exchange of a fixed amount of cash** or another financial asset for a **fixed number of the entity's** own equity instruments.

Revise liability and equity definition with this diagram



Concept capsule 5

A Ltd. (issuer) issues preference shares to B Ltd. (holder). Those preference shares are **redeemable at the end of 10 years** from the date of issue and entitle the holder to a **cumulative dividend of** 15% p.a. The rate of dividend is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Suggested answer

There is a contractual obligation to the entity to pay dividend & principal during the period of contract. This instrument is a financial liability.

Concept capsule 6

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Suggested answer

In the given case, this instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The **first component** is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

It means, even one component is creating contractual obligation – it should be classified as financial liability.

It is a compound financial instrument. We will be discussing it later in this chapter.

Concept capsule 7

LMN Ltd. issues preference shares to PQR Ltd. These preference shares are redeemable at the end of 5 years from the date of issue.

The instrument also provides a settlement alternative to the issuer whereby it can transfer a particular commercial building (non-financial asset) to the holder, whose value is estimated to be significantly higher than the cash settlement amount. Examine the nature of the financial instrument.

Suggested answer

As per para 20 of Ind AS 32, a financial instrument that **does not explicitly establish a contractual obligation** to deliver cash or another financial asset **may establish an obligation indirectly** through its terms and conditions.

In the given situation, although the entity does **not have an explicit contractual obligation** to deliver cash or another financial asset, the value of the commercial building settlement is significantly higher so the alternative is such that the entity will settle in cash. As, the preference shares are going to be settled in cash, it will be classified as **financial liability** irrespective of the alternatives available to the issuer.

Concept capsule 8

How to account for preference shares issued if they are redeemable at the option of **the entity (issuer)**? Will your answer change if the entity issued cumulative preferences shares?

Suggested answer

In this case, redemption of the shares is solely at the discretion of the issuer. An obligation arises only when the issuer exercises its option i.e. usually after formally notifying the shareholders regarding the redemption of shares.

As long as the option to redeem is not exercised by the issuer as at the balance sheet date, the issuer does not have a present obligation to transfer financial assets to the shareholders and, hence it should be accounted as an **equity instrument**.

One should consider the terms and conditions with respect to dividend liability. If dividend is an obligation as per the terms (which cannot be skipped), the entity should recognise financial liability to the extent that it is a contractual obligation (It is explained in one of the below concept capsules with the help of numbers), otherwise i.e. the dividend payment is at the discretion of the issuer, the shares should be classified as equity instruments.

It is a compound financial instrument. We will be discussing it later in this chapter.

Concept capsule 9 - Dividend payments linked to equity shares

A company issued non-redeemable preference shares with **dividend payments linked to equity shares** *i.e. preference dividend is paid only if the dividend is paid to equity share-holders*. Evaluate the classification of preference shares.

Suggested answer

As per Ind AS 32, equity is the instrument which includes **NO contractual obligation** to either (i) **to deliver cash or another financial asset** to another entity; or (ii) **to exchange** financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer;

In the given case, the principal amount of preference shares are irredeemable and the dividend payments are discretionary and not contractual, because no dividends can be paid if no dividends are paid on the ordinary shares, which are akin to an equity instrument.

As the perpetual preference shares contain no contractual obligation with respect to dividends and principal, it should be classified as equity in their entirety.

Concept capsule 10

Continuation to the above question, what would be your answer if the preference dividend is cumulative and deferrable indefinitely?

Suggested answer

In case, dividend payments are cumulative *i.e. if no dividend is paid on the ordinary shares, the preference dividend will be deferred,* the perpetual preference shares will be classified as equity **only if** the dividends can be **deferred indefinitely** and the entity does not have any contractual obligations whatsoever to pay those dividends. A liability for the dividend payable would be recognised once the dividend is declared.

Concept capsule 11

A Ltd. invests in **compulsorily convertible preference shares** (CCPS) issued by its subsidiary – B Ltd. at ₹ 1,000 each (₹ 10 face value + ₹ 990 premium). Under the terms of the instrument, each CCPS is compulsorily convertible into one equity share of B Ltd at the end of 5 years. Such CCPS carry dividend @ 12% per annum, payable only when declared at the discretion of B Ltd. Evaluate this under definition of financial instrument.

Suggested answer

B Ltd. has issued CCPS which provide for –

(a) Conversion into fixed number of equity shares, i.e. one equity share for every CCPS;

(b) Non-cumulative dividends.

Applying the definition of 'equity' under Ind AS 32 –

(a) There is **no contractual obligation to deliver cash** or other financial asset. Dividends are payable at the discretion of B Ltd., thereby resulting in **no contractual obligation** over B Ltd.

(b) Conversion is into a fixed number of equity shares.

Hence, it meets definition of **equity instrument** and shall be classified as such in books of B Ltd.

Concept capsule 12

Does the lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, will lead to contractual obligation?

Suggested answer

As per para 19 of Ind AS 32, Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate (nullify) the entity's contractual obligation or the holder's contractual right under the instrument. In other words, these are procedural matters and do not change the contractual position between the parties.

Concept capsule 13

CBA Ltd. issues convertible debentures to RQP Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into equity shares of CBA Ltd. using a pre-determined formula. The formula = 100 crores X $(1 + 10\%)^5$/**Fair value** on date of conversion

Examine the nature of the financial instrument.

Suggested answer

As per Ind AS 32, financial liability is defined as

a contract that <u>will or may</u> be <u>settled</u> in the entity's <u>own equity instruments</u> and is

(i) **a NON-DERIVATIVE** for which the entity is or may be obliged to deliver a **variable number of the entity's own equity instruments**;

In the given case, the entity is going to settle the obligation with variable number of its own equity instrument (*observe the denominator of the formula – it is fair value. Fair value changes day to day and results into variable number of shares*). This is not a derivative. As it satisfies the definition, it should be classified as financial liability.

The underlying thought behind this conclusion is that the entity is using its own equity instruments '**as currency**'.

Concept capsule 14

DF Ltd. issues convertible debentures to JL Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹ 10 each.

Examine the nature of the financial instrument.

Suggested answer

As per Ind AS 32, financial liability is defined as

a contract that will or may be settled in the entity's own equity instruments and is

(ii) A **DERIVATIVE** that will or may be settled for **OTHER THAN**

- By exchange of a **fixed amount of cash** (i.e. payable in variable amount is FL); or
- Another financial asset for a **fixed number of the entity's own equity instruments**;

In the given case, the contract is derivative as the value of contract changes due to change in fair value of equity share. As per the contract, entity has to pay fixed amount and for fixed number of shares – it does not satisfy the financial liability definition; it should be classified as equity instrument.

From the above two concept capsules you must have understood

"A contract that will be settled by the entity (receiving or) **delivering a fixed number** of its own equity instruments in exchange **for a fixed amount** of cash or another financial asset is an equity instrument

S. No.	Consideration for financial instrument	Number of own equity instruments to be issued in settlement	Classification and rationale
1.	Fixed	Variable	**Financial liability** – own equity instruments are being used as currency to settle an obligation for a fixed amount
2.	Fixed	Fixed	**Equity** – issuer does not have an obligation to pay cash and holder is not exposed to any variability
3.	Variable	Fixed	**Financial liability** – though issuer does not have an obligation to pay cash, but holder is exposed to variability
4.	Variable	Variable	**Financial liability** – though issuer does not have an obligation to pay cash, but both parties are exposed to variability

Concept capsule 15

WC Ltd. writes an option in favour of GT Ltd. wherein the holder can purchase issuer's equity instruments at prices that fluctuate in response to the share price of issuer.

As per the terms, if the share price of issuer is less than ₹ 50 per share, option can be exercised at ₹ 40 per share. If the share price is equal to or more than ₹ 50 per share, option can be exercised at ₹ 60 per share. Explain the nature of the financial instrument.

OR

Acquirer Ltd. enters into an arrangement with shareholders of Target Ltd. wherein Acquirer Ltd. will purchase shares of Target Ltd. in a share swap arrangement against a variable amount of cash i.e. market value of Target Ltd.'s equity shares. The share swap ratio is agreed as 1:5 i.e. 1 equity share of Acquirer Ltd. for every 5 equity shares held in Target Ltd. Examine whether the financial instrument will be classified as equity.

Suggested answer

This is a financial liability as the contract will be settled by delivery of **fixed number** of instruments for a **variable amount** of cash.

Go through the above definitions once again and try the following

Financial Instruments	Is it FA/FL/Equity?	Reason
Investment in Equity Shares		
Investment in Loans and Receivables		
Trade and other receivables		
Promissory Note to receive Govt. Bonds		
Debentures		
Deposits and advances received		
Deposits and advances given		
Bank Loans		
Sundry Creditors		
Inventories		
Property, Plant and Equipment		
Intangible Assets		
Prepaid Expenses		
Deferred Revenue Items		
Warranty Obligations		
Income Taxes		
Gold		
Gold Bonds		
Financial Guarantee		
Finance Lease		
Operating lease		
Lease liability recognised by Lessee		
Right to use asset *(You need to have Ind AS 116 knowledge)*		
Constructive Obligations		

Just check your answer. You may get doubt on few items – please go back to the definitions.

Financial Instruments	Is it FA/FL/Equity?	Reason
Investment in Equity Shares	Financial asset	As per the definition point (b);
Investment in Loans and Receivables	Financial asset	It gives a contractual right to receive either cash or any other financial asset;
Trade and other receivables	Financial asset	Same as above;
Promissory Note to receive Govt. Bonds	Financial asset	Contractual right to receive another financial instrument;
Debentures Issued	Financial liability	Contractual obligation to deliver cash or other financial asset;
Deposits and advances received	Financial liability	Contractual obligation to deliver cash or other financial asset;

Financial Instruments	Is it FA/FL/Equity?	Reason
Deposits and advances given	Financial asset	Contractual right to receive cash or other financial asset;
Bank Loans	Financial liability	Contractual obligation to deliver cash or other financial asset;
Sundry Creditors	Financial liability	Same as above;
Inventories	Not applicable	It is an asset held by the entity and NOT receivable from any one;
Property, Plant and Equipment	Not applicable	Same as above
Intangible Assets	Not applicable	Same as above
Prepaid Expenses	Not applicable	There is NO contractual right to receive cash or other financial asset; This is a right to receive services or product;
Deferred Revenue Items	Not applicable	This is an income which is already received and NO obligation to pay;
Warranty Obligations	Not applicable	It is an obligation to give either services or products and not cash or other financial asset;
Income Taxes	Not applicable	These are created as a result of statutory requirements imposed by government and these are accounted as per Ind-AS 12;
Gold	Not applicable	It is an asset held by the entity;
Gold Bonds	Financial asset	It is a right to receive cash or other financial asset;
Financial Guarantee	FA/FL	Contractual right of the lender to receive cash. Contractual obligation of the guarantor to pay the lender if the borrower defaults. A contingent right/obligation meet the obligation meet the definition of Financial instrument even though they are not recognised in the FS.
Finance Lease	FA/FL	It gives rise to a contractual right to receive cash to lessor and an obligation to lessee. The stream of payments is substantially same as principal and interest under a loan agreement.
Operating lease	Not applicable	It creates neither obligation nor a receivable asset in the books of the lessee and lessor, except individual payments currently due and payable;
Lease liability recognised by Lessee	FL	Lease creates an obligation to lessee and it is a monetary item (payable). This is recognised as per Ind AS 116. But its derecognition is dealt with Ind AS 109
Right to use asset	Not applicable	It is the right to use the asset. It is neither the right to receive money nor any other financial asset.
Constructive Obligations	Not applicable	Refer Ind-AS 37 – These do not arise from contracts and hence not financial liabilities and will be accounted as per Ind-AS 37.

Scope of Financial instruments i.e. Ind AS 109/32

The following satisfy the definition of financial instruments but these are **scoped out** from the standard. Just have a look at it.

Financial Instrument	Whether out of scope?		Applicable Ind AS
	Ind AS 109	Ind AS 32	
Interest in subsidiaries	Yes	Yes	110/27
Interest in associates	Yes	Yes	28/27
Interest in Joint Ventures	Yes	Yes	28/27
Rights and Obligations under **Leases**	Yes	No	116
Employer's rights and obligations under employee benefit plans	Yes	Yes	19 (employee benefits)
Financial instrument that meets the definition of an equity instrument			
Issuer's perspective	Yes	No	32
Holder's perspective	No	Yes	109
Rights and obligations under an insurance contract	Yes	Yes	104*
Financial guarantee contracts (discussed in the next topics)	No	No	32/109
Forward contract to buy or sell an acquiree that will result in a business combination at a future date	Yes	No	103*
Loan commitments	Yes	No	37*
Contracts for contingent consideration in business combination	No	No	103
Financial instruments, Contracts & obligations under share-based payment transactions	Yes	Yes	102
Right to receive payments as reimbursement of expenditure recognized as provision	Yes	Yes	37*
Commodity contracts to buy or sell non-inancial items **(See the concept capsules below)**			
- For expected purchase, sale or usage requirement	Yes	Yes	37*
- Not for expected purchase, sale or usage requirement	No	No	32/109

*Ind-AS 37 – Provisions, Contingent Liabilities and Contingent Assets;

Ind-AS 102 – Share based payment;

Ind-AS 103 – Business combinations;

Ind-AS 104 – Insurance contracts.

You may be aware of the words – Gross settlement and Net settlement.

Anyhow we give brief explanation below

In case of ,

Gross settlement – Real delivery takes place like regular mercantile transaction;

Net settlement – The differential amount will be exchanged.

Let us take an example – say entered a forward agreement to buy Infosys company share for ₹ 700 after 30 days; Assume after 30 days, the market value of the share is ₹ 750;

In case of Gross settlement, we get the Infosys share and we pay ₹ 700;

In case of Net settlement, we get ₹ 50 from the other party (i.e. the differential amount ₹750 – ₹700) (no physical delivery) – in case of net settlement, Cash (a financial asset) is either received or paid depending upon the market value of the underlying asset on the exercise date.

Hope you got it

Scope more exceptions to the standard

Contracts to **buy or sell non-financial items** for the purpose of **the receipt or delivery as per the entity's expected purchase, sale or usage requirements**, are **OUTSIDE the scope** of the standard (Gross settlement for its own use).

Such contract to buy or sell non-financial items will be **covered by the standard when the contract can be NET settled**; (Not physical delivery)

The following are the **various ways to settle in net**. It includes

(a) when the contract permit **either party to settle it net** in cash or another financial instrument or by exchanging financial instruments;

(b) Irrespective of the ability to settle in net – One should consider the entity's past practice of settling similar contracts **net** in cash or another financial instrument or by exchanging financial instruments;

(c) When the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery in similar contracts for the purpose of **generating a profit from short-term fluctuations** in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash;

In the above circumstances, the contract will be accounted as a financial instrument as per Ind AS 109.

In addition to the above points – if the contract is designated as FVTPL, It will be covered by this standard.

Before recognition and measurement – you need to understand many concepts such as derivative, puttable instruments, etc.,

Derivatives *(Students are requested to revise "Derivatives" chapter in Strategic Financial Management)*

An instrument is called a derivative when it has **ALL** the following conditions (as per Ind AS 109)

i. Whose **value changes** in response to **changes in an underlying asset**, price or index

ii. That **requires little or no initial investment** (or significantly less than the investment required to purchase the underlying instrument)

iii. That is settled at future date.

Question 1

Is an "OPTION CONTRACT" a derivative? If yes, is it a financial instrument and how?

Let us try to understand this with an example

Say, Entity A holds an **option to purchase** (Call option) equity shares in Wipro Ltd for ₹500 per share at the end of a 90 day period.

In the given case,

1. Value of the option changes based on market price of Wipro company share (share is the underlying asset);
2. To buy an option, holder should pay premium amount which is little compared to market price of the share;
3. This contract will be settled after 90 days;

As the option contract satisfies all the conditions, **it is a derivative.**

Now the question is this a financial instrument?

Call option gives a **contractual right to exchange cash** of ₹500 for **an equity share** in another entity *(equity instrument in another entity is a financial asset).* Say the market value of the share is ₹ 600 at end of 90 days, the entity will exercise as it is favourable.

As the entity has a contract right to exchange one financial asset with another financial asset which is potentially favourable – it is a **financial asset**.

On the other hand, if entity A writes an option

Under this circumstance, entity A has an obligation to settle *(as you know, writer has an obligation to settle when the holder exercises the option)* which the counterparty can force the entity to sell equity shares in the listed entity B for ₹500 per share at any time in the next 90 days. That means, entity A has a contractual obligation to exchange equity shares in another entity for cash of ₹500 per share on **potentially unfavourable terms** if the holder exercises the option, because the market price per share may exceed the exercise price of ₹500 per share at the end of the 90 day period, hence it is a financial liability.

Question 2

Is forward/future contract a derivative? If yes, it is a financial instrument?

Let us take a foreign currency forward i.e. forward agreement entered with the banker to buy 1000$ at ₹ 72 after 90 days.

In case of forward & future contract, both the parties have to perform their duties i.e. Seller has to sell and buyer has to buy at the initially agreed price i.e. fixed amount.

In this case,

1. Value of the contract changes based on value dollar (dollar is the underlying asset);
2. In case of forward - No investment is required; In case of a future contract – both the parties deposit money (margin money) it is like security deposit to avoid default (not an expense/income) – that is not treated as investment;
3. This contract will be settled after 90 days;

As the forward/future contract satisfies all the conditions, **it is a derivative.**

Forward and future contract are financial instruments as it gives one party a contractual right to exchange financial assets or financial liabilities with another party

Under the conditions, it may be **potentially favourable** to one party – which recognises it as financial asset; and for the other party, it will be **potentially unfavourable –** it should recognise it as financial liability.

Question 3

Is Share warrant a derivative?

The holder of the share warrant has the right to buy fixed number of shares of the entity at fixed price.

In this case,

1. Value of the contract changes based on market value of the shares (Share is the underlying asset);
2. No initial investment is required;
3. This contract will be settled at a future date;

As the forward/future contract satisfies all the conditions, **it is a derivative.**

Look at the following derivative contracts and its underlying variables (*observe carefully*)

Type of Contract	Underlying Variables
Interest Rate Swap	Interest Rate
Currency Swap (Foreign Exchange Swap)	Currency rates

Type of Contract	Underlying Variables
Commodity Swap	Commodity prices
Equity Swap	Equity prices (equity of another entity)
Currency Futures	Currency rates
Commodity Futures	Commodity prices
Interest Rate forward Linked to Government Debt	Interest rates
Currency Forward	Currency rates
Commodity Forward	Commodity prices
Equity Forward	Equity prices (equity of another equity)
Purchased or Written Treasury Bond Option (call or put)	Interest rates
Purchased or Written Currency Option (call or put)	Currency rates
Purchased or Written Commodity Option (call or put)	Commodity prices

Concept capsule 16

A Ltd enters into an interest rate swap with a counterparty B Ltd that requires A Ltd to pay a fixed rate of 10% and receive a variable amount based on three-month LIBOR settled on a quarterly basis. The fixed and variable amounts are determined based on ₹1,000 lakh notional amount. A Ltd and B Ltd do not exchange the notional amount. A Ltd pays or receives a net cash amount each quarter based on the difference between 10% and three-month LIBOR. Alternatively, settlement may be on a gross basis. Decide whether does it make any difference if derivative is settled on gross basis or net basis?

Suggested answer

As per Ind AS 109, derivatives are those which change in response to change in underlying asset, require no initial investment or net initial investment is lower than required for a similar contract and is settled at future date.

In the given case, A Ltd is paying fixed rate of 10% but receiving 3 month LIBOR which is variable and receipt is dependent of LIBOR. If LIBOR increase from 10%, A Ltd will get benefit and if LIBOR will be less than 10% then A Ltd will lose. It means, the value of the contract changes due to change in interest rates i.e. underlying asset; Interest rate swaps does not require any initial investment and as it is clearly said, it will be settled at a future date.

All the conditions of derivative are satisfied, hence transaction is classified as derivative transaction. It is irrelevant whether transaction is settled gross or net – as in case of both gross and net settlement – money (a financial asset) is only exchanged**;**

Concept capsule 17

Entity XYZ enters into a fixed price forward contract to purchase **one million kilograms of copper** in as per its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of 12 months **or** to pay **or** receive a net settlement in cash, based on the change in fair value of copper. If the entity intends to take physical delivery of copper and it has no history of net settlement, how do you treat this forward contract? If the entity wants to net settlement in cash, does accounting treatment change?

Suggested answer

As per Ind AS 109, derivatives are those which change in response to change in underlying asset, require no initial investment or net initial investment is lower than required for a similar contract and is settled at future date.

In the given case, the value of forward changes based on copper value which is the underlying asset, in case of forward – NO initial investment and which will be settled at a future date. As it satisfies all the conditions, it is a derivative instrument.

As per Ind AS 32, financial asset is any asset that gives contractual right to exchange **financial assets** or financial liabilities which is potentially favourable to the entity.

If the entity accepts the GROSS settlement for its business purpose i.e. own purpose

The company pays cash (financial asset) and **receives copper** which is **non-financial asset**; It is not a financial instrument as in the exchange both should be financial items. If it is not clear on the date of entering into the contract, one should evaluate the past practice of the company and accordingly account for it.

If the entity accepts the NET settlement

In this case, the entity either receives or pays the differential amount i.e. difference between the agreed price and fair value on the date of settlement. Cash is being financial asset and exchange is either favourable or unfavourable to the entity – it is a financial asset/liability;

If the entity accepts the GROSS settlement – Selling it in short period after delivery (Not for its own use)

In this case, the company takes the delivery and immediately after delivery it sells to another party for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. This is equal to net settlement. Hence, it is a financial item and will be accounted for as per this standard.

Concept capsule 18

BEE Ltd has entered into a contract by which it has the option to sell its identified property, plant and equipment (PPE) to AXE Ltd for ₹100 lakh after 3 years whereas its current market price is ₹150 lakh. Is the put option of BEE Ltd. a financial instrument? Explain ***(CA Final – Nov 2011)***

Suggested answer

As per Ind AS 32, Financial instrument is any contract that gives rise to an FA of one entity and an FL or equity instrument of another entity.

In the given case, one cannot give a direct answer without evaluating the past practice of the company.

- If BEE Ltd has the past practice of **net settlement**, then it becomes a financial instrument and account for as per Ind AS 109;
- If BEE Ltd. intends to sell the identified PPE and **settle by delivery** and there **is no past practice** of settling net, then the contract is **scoped out** of Ind AS 109.

Concept capsule 19 ***(CA Final – Nov. 2010)***

M/s TS Ltd. has entered into a contract by which it has **the option to sell its specified asset** to NB Ltd. for ₹100 lakh after 3 years whereas the current market price is ₹150 lakh. Company **always settles account by delivery**. What type of option is this? Is it a financial instrument? Explain with reference to the relevant Ind AS.

Suggested answer

As per IndAS 32, a financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

In the given case, M/s TS Ltd. has entered into a contract with NB Ltd. and company settles its account **by delivery**, and does not give rise to any financial asset or financial liability. Hence there is no option. Since, the above transaction does not give rise to a financial asset of one entity and a financial liability or equity instrument of another entity; this is **not** a financial instrument and scoped out of Ind AS 109.