CHAPTER

27

IND AS 109, 32 & 107— FINANCIAL INSTRUMENTS

SYNOPSIS

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 necessity 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.

A contract
which

Creates in **Party 1** books
- ❖ Financial asset

Creates in **Party 2** books
Either
- ❖ Financial Liability; OR
- ❖ Equity

'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 obtains 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

Examples: *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**

(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.

Try Practice Question 1 & 2 in Volume II of Ind as Made easy

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 following 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 is 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 **<u>either of (A) or (B)</u>** below: **Condition (A):** An instrument that **<u>is a contractual obligation</u>**: 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.	A financial instrument that fulfils **<u>both (A)</u>** **<u>and (B)</u>** below: **Condition (A):** An instrument that contains **<u>NO</u> 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.

Concept capsule 3

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 4

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 AS32, 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 5 - 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 6

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.

Try Practice Question 3 & 4 in Volume II of Ind as Made easy

Concept capsule 7

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 $(1 + 10\%)^{\wedge 5}$ / **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 changed 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**'.

Try Practice Question 5 in Volume II of Ind as Made easy

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 8

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.

Self-test

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 another financial asset;
Deposits and advances received	Financial liability	Contractual obligation to deliver cash or another financial asset;
Deposits and advances given	Financial asset	Contractual right to receive cash or another financial asset;
Bank Loans	Financial liability	Contractual obligation to deliver cash or another 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 another 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 another financial asset;

Financial Instruments	Is it FA/FL/ Equity?	Reason
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 by Ind AS-109
Right of 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.

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

Anyhow we gave 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

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 days 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