CHAPTER 11

ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Define financial asset, financial liability and equity
- Examine the scope of financial instruments and items excluded from scope of financial instruments
- Understand the application of these definitions and scope to different forms of instruments
- Determine whether the financial instruments such as preference shares, debentures and bonds will be classified under "equity" or "financial liabilities" or components thereof will be classified under both
- Apply necessary accounting principles for determining when a financial liability can be offset with a financial asset
- Apply accounting principles for recognition of financial assets and financial liabilities
- Classify financial asset and financial liability
- Determine the accounting treatment for regular way purchase or sale of financial assets

© The Institute of Chartered Accountants of India

- Measure financial assets initially and subsequently
- Measure financial liability initially and subsequently
- Reclassify the financial instrument and deal with the accounting aspect upon reclassification
- Acquire the conceptual understanding of “derivatives” and “embedded derivatives”,
- Identify the situations in which embedded derivatives need to be separated and
- Deal with the Accounting principles in the situations in which embedded derivatives are so separated
- Identify the hedged items
- Designate the items as hedged items/instruments
- Qualify instruments for hedge accounting
- Determine the criteria for qualifying the items as hedge items and its accounting.
- Determine whether or not a transfer qualifies for derecognition and accounting treatment in various situations
- Apply accounting principles for derecognition of financial liabilities, including evaluating practical complexities involved in exchange of financial instruments or parts thereof
- Disclose necessary details regarding financial instruments as per the standards

© The Institute of Chartered Accountants of India

CHAPTER OVERVIEW

The chapter is divided into 7 units-

a) **Unit 1 'Financial Instruments: Scope and Definitions'** deals with a brief introduction of financial instruments, definitions of financial instrument, financial asset, financial liability and equity instrument. It also discusses the contracts which are included and excluded from the scope of the standards on Financial Instruments.

b) **Unit 2 'Classification and Measurement of Financial Assets and Financial Liabilities'**, deals with criterias for classification, measurement (initially and subsequently), reclassification of financial assets and financial liabilities. It further discusses impairment of financial assets.

c) **Unit 3 'Financial Instruments: Equity and Financial Liabilities'** covers the analysis of the definition of financial liabilities and equity. It also deliberates critical features in differentiating a financial liability from an equity instrument and delves into various aspects which help in determining the liability as financial liability. The unit also explains when an instrument is a compound financial instrument. It also analyses treasury shares, interest, dividends, losses and gains. Finally, it elucidates offsetting a financial asset and financial liability.

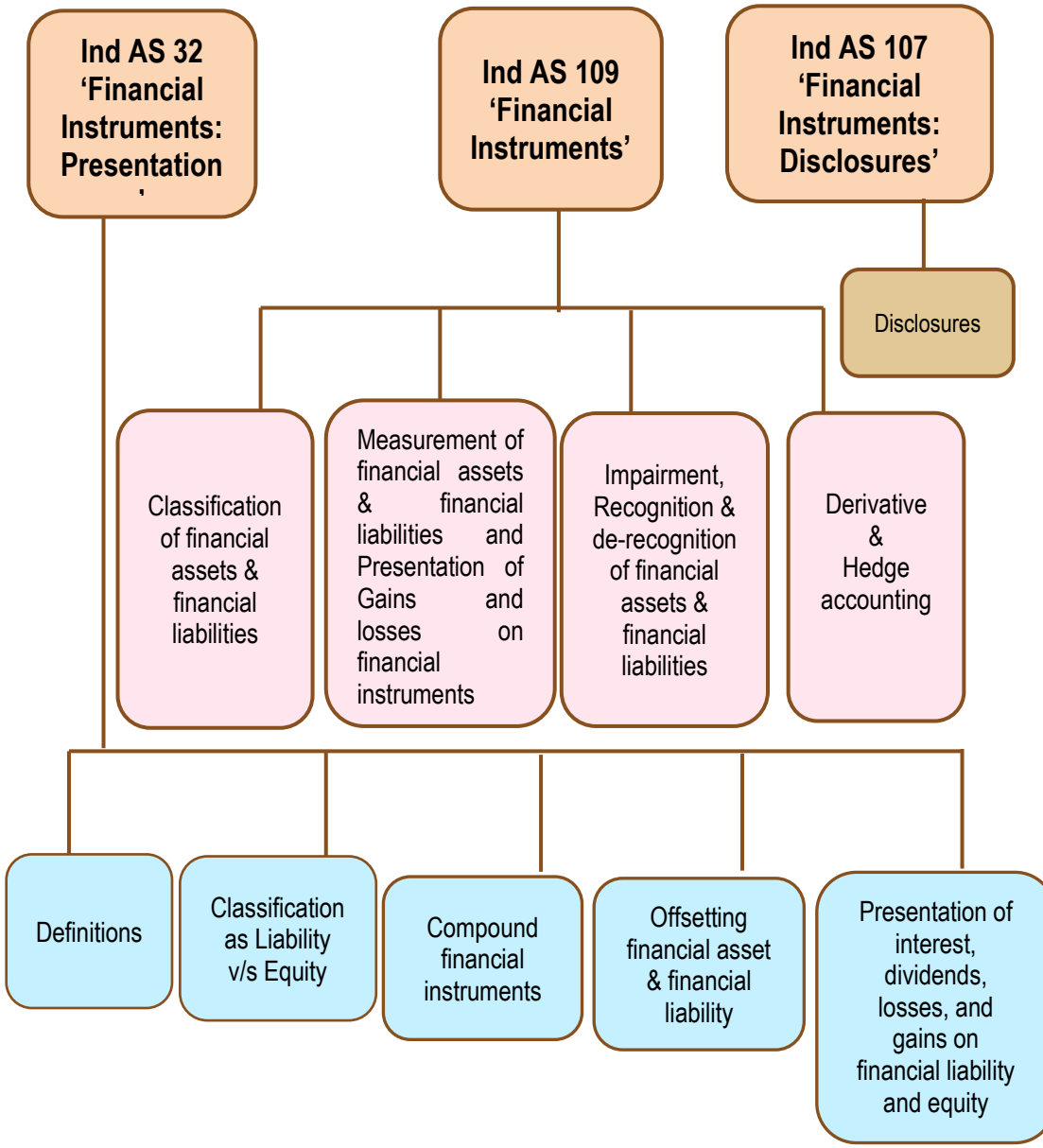
d) **Unit 4 'Derivatives and Embedded Derivatives'** defines the two derivatives with examples and the manner of separating the embedded derivatives from the host contract alongwith the characteristics differences and deals with the accounting thereof.

e) **Unit 5 'Recognition and Derecognition of Financial Instruments'** covers guidance prescribed in the standard on initial recognition of financial instruments. It also takes into account, the timings of recognition and accounting treatment under various situations. Later on, it discusses the derecognition of financial instruments and situations under which derecognition will be considered or not. The unit also covers the extinguishment and modification of financial liabilities and accounting of debt for equity swaps.

f) **Unit 6 'Hedge Accounting'** covers identification and designation of hedge items, criteria qualifying an item as hedge item and accounting thereof.

g) **Unit 7 'Disclosures'** covers disclosure requirements as stated in the standard.

© The Institute of Chartered Accountants of India



© The Institute of Chartered Accountants of India

UNIT 1:
FINANCIAL INSTRUMENTS: SCOPE AND DEFINITIONS

1.1 INTRODUCTION

With the changing landscape of Indian economy and more liberalisation, raising funds in national and international markets through different forms of instruments has gathered momentum. As companies expand their horizon, investors at the same time are getting cautious to invest through different means to achieve their intended objective, which could have fixed return like a debt instrument or a residual share in net assets like equity or both. Several type of instruments are issued like convertible preference shares, FCCBs, foreign currency loans, debt syndication arrangements, loans from group companies, etc. by borrowing entities for raising funds. Accounting treatment of these instruments in the books, with introduction of Indian Accounting Standards (Ind AS) is important for us to understand to reflect proper financial reporting for users of financial statements that provides relevant and faithful representation of the financial performance, financial position, and cash flows of the reporting entity.

MCA notified following Ind AS to deal with accounting of financial instruments:

- Ind AS 109 – Financial instruments
- Ind AS 32 – Financial instruments: Presentation
- Ind AS 107 – Financial Instruments: Disclosures

These Ind AS are largely aligned with the prevailing guidance in IFRS which require classification of a financial instrument based on substance of the arrangement between the parties rather than their legal form and the definition of financial asset, financial liability and equity. Further, recognition and measurement criteria are also driven based on classification of such instruments.

© The Institute of Chartered Accountants of India

1.2 WHAT ARE FINANCIAL INSTRUMENTS?

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.

- Here, a ***contract*** refers to an agreement between two or more parties that has clear economic consequences and which parties usually are bound to adhere, usually because the agreement is enforceable by law.
- Contracts need not be in writing and may take a variety of forms.
- An important point to note is any assets or liabilities that are not contractual are not financial liabilities or financial assets. For eg.: income taxes are a statutory obligation and not arising from contract, constructive obligations as defined in Ind AS 37 – Provisions, Contingent Liabilities and Contingent Assets do not arise from contracts and hence, are not financial liabilities, etc.
- Financial instruments include:

  (a) Primary instruments (such as receivables, payables and equity instruments) and

  (b) Derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps).

While the examples above provide an indication of what financial instruments comprise, let's understand the definition of each of these type of financial instruments in greater detail.

1.3 WHAT IS A FINANCIAL ASSET?

A **'financial asset'** is any asset that is:

(a) **Cash;**

(b) An equity instrument of another entity;

(c) A **contractual** right:

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

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

© The Institute of Chartered Accountants of India

(d) a contract that will or may be settled in **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 entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by exchange of fixed amount of cash or another financial asset for a fixed number of entity's own equity instruments. For this purpose, 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 net assets of the entity on liquidation and are classified as equity instruments, or instruments that are themselves contracts for future receipt or delivery of entity's own equity instruments.

On the basis of the above definition, a financial asset can be either of the following –

Financial asset

Common examples
- Cash
- Trade receivables
- Investments in bonds and deposits
- Investment in equity instruments
- Loans receivable, etc.

♦ On the basis of the above definition, some of the key elements to understand:

Cash

- Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements.
- A deposit of cash with bank or other financial institution represents a contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

© The Institute of Chartered Accountants of India

Contractual right to receive cash or other financial asset	❖ A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument. Common examples of contractual right to receive cash and corresponding financial liability representing other party's contractual obligation to deliver cash in future are: 1. Trade receivables; 2. Loans and Notes receivable 3. Deposits made; 4. Investment in bonds, etc. ❖ The ability to exercise a contractual right or to satisfy a contractual obligation may be absolute or it may be contingent on occurrence of one or more future events, not wholly within the control of either party to the contractual arrangement. ❖ A contingent right and obligation meets the definition of financial asset and financial liability, even though such assets and liabilities are not always recognized in financial statements. For eg.: A lender may be provided with a financial guarantee by a party ('guarantor') on behalf of borrower, entitling to recover the outstanding dues from the guarantor if the borrower were to default, etc. It may be noted that paragraph 2 of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' excludes from its scope financial instruments within the scope of Ind AS 109. Therefore, financial guarantee contracts cannot be disclosed as contingent liability.

© The Institute of Chartered Accountants of India

- **Physical assets, right-of-use assets and intangible assets**
  - Physical assets (such as inventories, property, plant and equipment), right-of-use assets and intangible assets (such as patents and trademarks) are not financial assets.
  - Control of such physical assets, right-of-use assets and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.
- **Prepaid expenses**
  - Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
  - Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.
- **'Perpetual' debt instruments**

  Perpetual debt instruments such as 'perpetual' bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

Example 1

Evaluate the financial assets.

S. No.	Particulars	Whether FA or not	Remarks
1	Investment in bonds debentures	FA	• Contractual right to receive cash.
2	Loans and receivables	FA	• Contractual right to receive cash.
3	Deposits given	FA	• Contractual right to receive cash.
4	Trade & other receivables	FA	• Contractual right to receive cash.
5	Cash and cash equivalents	FA	• Specifically covered in the definition.
6	Bank balance	FA	• Contractual right to receive cash.

© The Institute of Chartered Accountants of India

S. No.	Particulars	Whether FA or not	Remarks
7	Investments in equity shares	FA	• Equity instrument of another entity.
8	Perpetual debt instruments Eg. perpetual bonds, debentures and capital notes.	FA	• Such instruments provide the contractual right to receive interest for indefinite future or a right to return of principal under terms that make it very unlikely or very far in the future.
9	Physical assets Eg. inventories, property, plant and equipment etc.	No	• Control of such assets does not create a present right to receive cash or another financial asset.
10	Right to use assets Eg. Lease vehicle etc.	No	• Control of such assets does not create a present right to receive cash or another financial asset.
11	Intangibles Eg. Patents, trademark etc.	No	• Control of such assets does not create a present right to receive cash or another financial asset.
12	Prepaid expenses Eg. Prepaid insurance, prepaid rent etc.	No	• These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.
13	Advance given for goods and services	No	• These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.

Illustration 1: Trade receivables

A Ltd. makes sale of goods to customers on credit of 45 days. The customers are entitled to earn a cash discount @ 2% per annum if payment is made before 45 days and an interest @ 10% per annum is charged for any payments made after 45 days.

Evaluate whether such trade receivable are financial assets or not.

Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

© The Institute of Chartered Accountants of India

In the above case, A Ltd. has the contractual right to receive cash /bank from its trade receivable recorded in its books of accounts, after the expiry of credit period of 45 days or earlier after passing discounts of 2 % per annum.

Hence, trade receivables would meet the definition of financial assets.

It may be noted that contractual right to receive cash includes contractual right to receipt of money in bank account or any wallet account.

*****

Illustration 2: Deposits

Z Ltd. (the 'Company') makes sale of goods to customers on credit. Goods are carried in large containers for delivery to the dealers' destinations. All dealers are required to deposit a fixed amount of ₹ 10,000 as security for the containers, which is returned only when the contract with Company terminates. The deposits carry 8% per annum which is payable only when the contract terminates.

If the containers are returned by the dealers in broken condition or any damage caused, then appropriate adjustments shall be made from the deposits at the time of settlement.

How would such deposits be treated in books of the dealers?

Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

In the above case, such security deposits are receivable in cash at the end of contract period between the dealer and the Company.

Hence, they meet the definition of financial assets.

*****

1.4 WHAT IS A FINANCIAL LIABILITY?

- A **financial liability** is any liability that is:

  (a) A contractual obligation:

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

© The Institute of Chartered Accountants of India

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

Or

(b) A contract that will or may be settled in 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 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, 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 the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are 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.

As an exception, following type of instruments that meets the definition of a financial liability may still be classified as an equity instrument if they have certain features and meets specific conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32. The definition of financial liability includes a carve-out from IAS 32 that the variablilty due to foreign currency shall be ignored while classifying a foreign currency convertible bond as equity or liability or compound financial instrument.

For details, refer Unit 3 – Equity and Financial Liabilities.

© The Institute of Chartered Accountants of India

Financial liability

Common examples

- Loans and borrowings
- Payables for purchase of goods & services
- Finance lease liabilities
- Redeemable instruments like preference shares, debentures, etc.
- Guarantee given for repayment of debt upon borrower's default

Example 2

Evaluate the financial Liability.

S. No.	Particulars	Whether FL or not	Remarks
1	Loans payable or bank loan	FL	• Contractual obligation to pay cash.
2	Trade and other payables	FL	• Contractual obligation to pay cash
3	Bills payable / acceptance	FL	• Contractual obligation to pay cash.
4	Deposits received	FL	• Contractual obligation to pay cash.
5	Mandatory redeemable preferences shares	FL	Contractual obligation to pay cash.
6	Financial guarantee given (Also see the scope section to understand when financial guarantee contract can be regarded as insurance contract)	FL	• Contractual obligation to pay cash, due to the occurrence of certain events.

Illustration 3: Perpetual debt instruments

A Ltd. issues a bond at principal amount of CU 1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8 per cent applied to the principal amount of CU 1,000. Assuming 8 per cent 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 CU1,000 on initial recognition.

Evaluate the financial instrument in the hands of both the holder and the issuer.

© The Institute of Chartered Accountants of India

Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

- For the Holder – There is right to receive cash in future. Hence, it will be classified as a financial asset
- For the Issuer – There is contractual obligation to pay cash in future. However, the instrument is redeemed at the option of A Ltd. or on liquidation of A Ltd. Therefore, the instrument has characteristics of both equity and financial liability. Such an instrument is regarded as compound financial instrument (Ref. para 28 of Ind AS 32). See Unit 3 to understand accounting for compound financial instrument.

*****

Illustration 4: Creditors for sale of goods

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% per annum for any delays beyond the credit period.

Analyse whether the transaction leads to any financial instruments and if yes, then what is the nature of that financial instrument?

Solution

A financial liability is any liability where there is a contractual obligation to deliver cash or other financial asset to another entity.

In the above case, A Ltd. has entered into a contractual arrangement for purchase of goods at a fixed consideration payable to the creditor. A contractual arrangement that provides for payment in fixed amount of cash to another entity meets the definition of financial liability.

*****

Illustration 5: Contract for exchange on unfavorable conditions

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% per annum. 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 1,300,000 at the end of 6th year for one time settlement, in lieu of defaults in payments made earlier.

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

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

© The Institute of Chartered Accountants of India

Solution

(a) A Ltd. has entered into an arrangement wherein against the borrowing, A Ltd. has contractual obligation to make stream of payments (including interest and principal). This meets definition of financial liability.

(b) Let's compute the amount required to be settled and any differential arising upon one time settlement at the end of 6th year –

- ❖ Loan principal amount = ₹ 10,00,000
- ❖ Amount payable at the end of 6th year = ₹ 12,54,400 [10,00,000 x 1.12 x 1.12 (Interest for 5th & 6th year in default plus principal amount)]
- ❖ One time settlement = INR 13,00,000
- ❖ Additional amount payable = ₹ 45,600

The above represents a contractual obligation to pay cash against settlement of a financial liability under conditions that are unfavorable to A Ltd. (owing to additional amount payable in comparison to amount that would have been paid without one time settlement). Hence the rescheduled arrangement meets definition of 'financial liability'.

*****

1.5 WHAT IS AN EQUITY INSTRUMENT?

- ♦ As per Ind AS 32.11 – An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- ♦ As per Ind AS 32.16 – An instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:

(a) The instrument includes **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 issuer.

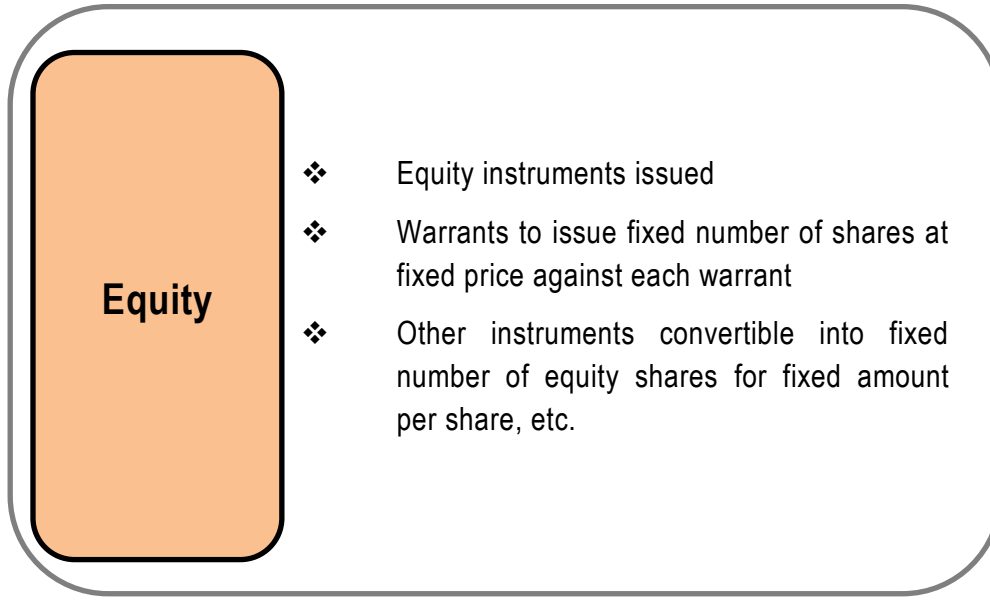
(b) If the instrument will or may be settled in the **issuer's own equity instruments**, it is:

© The Institute of Chartered Accountants of India

(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. 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 the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.



© The Institute of Chartered Accountants of India

- The **key characteristics** of an equity instrument have been further explained as follows:

No contractual obligation	❖ A key characteristic of equity instruments is that they carry no contractual obligation throughout for any payment or distribution towards the holders of such instruments. ❖ However, following type of instruments as an exception are 'equity' classified even if they contain an obligation to deliver cash or other financial asset, provided certain requisite criteria are met – 1. puttable financial instruments that meet certain conditions 2. an instrument, or a component of an instrument, that contains an obligation for the issuing entity to deliver to the holder a pro rata share of the net assets of the issuing entity only on its liquidation. The nature of these instruments and the criteria to be met for equity classification are explained in greater detail in Unit 3 – Financial Instruments : Equity and Financial Liabilities.
Settlement in own equity instruments	❖ Settlement in own equity instruments is equity classified only if it's a fixed-for-fixed transaction, ie, issue of fixed number of shares and involves a fixed amount of cash or other financial asset. ❖ Where an entity enters into a non-derivative contract to issue a fixed number of its own equity instruments in exchange for a fixed amount of cash (or another financial asset), it is an equity instrument of the entity. But this does not apply for instruments that are equity classified being a puttable instrument or other instrument entitling the holder to pro-rata share in net assets that meet specified criteria (refer Unit 3 – Equity and Financial Liabilities). ❖ However, if such a contract contains an obligation for the entity to pay cash (or another financial asset), it also gives rise to a liability for the present value of the redemption amount. For example: a forward contract entered into by an entity to repurchase fixed number of its own shares for a fixed amount of cash gives rise to a financial liability to be recorded at present value of redemption amount.

- An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the

© The Institute of Chartered Accountants of India

case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

Example 3

When a Company proposes dividend in its board meeting, no obligation arises because it becomes payable only post approval by shareholders in the annual general meeting. However, when the dividend is approved by shareholders in annual general meeting, the Company has taken an obligation to distribute dividend to its shareholders and hence it's a contractual obligation meeting the definition of financial liability.

- **Examples** of equity instruments include:
  - Non-puttable ordinary shares, for eg.: equity shares issued by companies
  - Some puttable instruments (if they meet requisite criteria and are not classified as financial liabilities);
  - Some 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 (if they meet requisite criteria and are not classified as financial liabilities);
  - Some types of preference shares (where repayment and distribution is at the discretion of the Issuer);
  - Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.
- Basis the above definition of equity and characteristics of such instruments, let's evaluate some typical form of instruments that may be issued and how are they classified –
  - **Preference shares**

    Preference shares is a class of shares issued by Indian companies, whose terms may provide for redemption at a pre-determined amount with a fixed return which may be cumulative or discretionary. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attached to the share to determine whether it exhibits the fundamental characteristic of a financial liability or an equity instrument, as explained in the following table.

© The Institute of Chartered Accountants of India

(A) Redeemable preference shares:

Redemption terms	Evaluation under Ind AS 32
Redemption at a specified date	This contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. **Hence, classified as 'financial liability'.**
Redemption at option of Holder	
Redemption at option of Issuer	An option of the issuer to redeem shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. **Hence, classified as 'equity instrument'**. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares, at which time this instrument shall be reclassified from 'equity' to 'financial liability'.

(B) Non-redeemable preference shares

Non-redeemable preference shares may be issued by foreign subsidiaries or foreign branches or foreign associates or foreign joint operations or foreign joint ventures. In this case, appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

- When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.
- The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

  (a) a history of making distributions;

© The Institute of Chartered Accountants of India

(b) an intention to make distributions in the future

(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares)

(d) the amount of the issuer's reserves

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Hence, the contractual terms determine the nature of instrument. Any historical trend or ability of the Issuer does not affect the classification of an instrument as 'equity' or 'financial liability'.

(C) Distributions on preference shares

Other than the terms for redemption of financial instrument, another important point for consideration is whether the Company has an obligation to make payments of dividend ie, whether dividend on such preference shares are cumulative or non-cumulative.

- **Where dividends are at the discretion of the issuer –** this is akin to an equity instrument. However, where the instrument itself is redeemable, the obligation to pay still exists but only to the extent of the redemption value and not dividends on such shares unless they are declared.
- **Where dividends are cumulative but payable only on liquidation–** One needs to assess the key terms of the instrument to check if the entity has a contractual obligation:

  (a) Where no contractual obligation exists to pay– such preference shares may themselves be irredeemable and the dividend on such shares even if cumulative, the entity may be under no obligation to pay unless upon liquidation – then such preference shares may be classified as equity.

  (b) Where contractual obligation exists – In cases where the preference shares are not redeemable, it is like an equity instrument. But if they are entitled to dividend which is payable

© The Institute of Chartered Accountants of India

such that entity does not have an unconditional right to defer payment, then this provides the shareholders with a lender's return on the amount invested. This obligation is also not negated if the entity is unable to pay such dividend for lack of funds or insufficient distributable profits. Therefore, the obligation to pay dividend meets the definition of financial liability. The instrument in such cases shall have two components – financial liability represented by dividend and equity component represented by the issue price, such instruments are overall classified as 'compound financial instruments' and each of the components as mentioned above are accounted separately.

Illustration 6: Preference shares with non-cumulative dividend

Silver Ltd. issued irredeemable preference shares with face value of ₹ 10 each and premium of ₹ 90. These shares carry dividend @ 8% per annum, however dividend is paid only when Silver Ltd declares dividend on equity shares. Analyse the nature of this instrument.

Solution

In the above case, two main characteristics of the preference shares are:

(i) Preference shares carry dividend, which is payable only when Company declares dividend on equity shares

(ii) Preference share are irredeemable.

Analysing the definition of equity, an instrument meets definition of equity if:

(a) It contains no contractual obligation to pay cash; and

(b) Where an instrument shall be settled in own equity instruments, it's a non-derivative contract that will be settled only by issue of fixed number of shares or a derivative contract that will be settled by issue of fixed number of shares for a fixed amount of cash.

In the above instrument, there is no contractual obligation on the Company to pay cash since –

(i) Face value is not redeemable (except in case of liquidation); and

(ii) Dividend is payable only if Company declares dividend on equity shares. Since dividend on equity shares is discretionary and the Company can choose not to pay, Company has an unconditional right to avoid payment of cash on preference shares also.

Hence preference shares meet definition of equity instrument.

*****

© The Institute of Chartered Accountants of India

- **Contracts settled in own equity instruments but classified as 'financial liability' (where equity instrument is treated as currency) –**

Terms	Evaluation under Ind AS 32
Non derivative contract	♦ A contract that will be settled in a variable number of entity's own shares whose value equals a fixed amount is a financial liability, because the entity is under an obligation to pay a fixed amount, that is settled through equity instruments (similar to settlement in currency). ♦ Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.
Derivative contract	♦ A contract that will be settled in a variable number of the entity's own shares whose value equals an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. ♦ An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract.

Illustration 7: Non-derivative contract to be settled in own equity instruments

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.

Solution

B Ltd. has issued CCPS which provide for –

(a) Conversion into fixed number of equity shares, ie, one equity share for every CCPS

(b) Non-cumulative dividends.

© The Institute of Chartered Accountants of India

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 only when declared and hence, at the discretion of the Issuer – 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.

*****

Illustration 8: Settlement in variable number of shares

Target Ltd. took a borrowing 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.

Solution

In the above scenario, Target Ltd. is under an obligation to issue variable number of equity shares equal to a total consideration of ₹ 10,00,000. Hence equity shares are used as currency for purpose of settlement of an amount payable by Target Ltd.

Since this is variable number of shares to be issued in a non-derivative contract for fixed amount of cash, it tantamounts to use of equity shares as 'currency' and hence this contract meets the definition of financial liability in books of Target Ltd.

*****

1.6 COMPARISON OF FINANCIAL ASSETS, FINANCIAL LIABILITIES AND EQUITY

Sl. No.	Financial Assets	Financial liabilities	Equity
1	Cash	-	-
2	An equity instrument of another entity.	-	-

© The Institute of Chartered Accountants of India

3.	**A contractual right** To receive cash or another financial asset from another entity Or	**A contractual obligation** To deliver cash or another financial asset to another entity Or	**No contractual obligation** To deliver cash or another financial asset to another entity. Or
3	To exchange financial assets or financial liabilities with another entity under conditions that are **potentially favourable** to the entity.	To exchange financial assets or financial liabilities with another entity under conditions that are **potentially unfavourable** to the entity.	To exchange financial assets or financial liabilities with another entity.
4	A contract that will or may be settled in the entity's own equity instruments.	A contract that will or may be settled in the entity's own equity instruments including derivative and non-derivative **(Variable no. of shares. and Fixed for Fixed criterion not met).**	A contract that will or may be settled in the entity's own equity **instruments (Fixed for Fixed criterion met).**

1.7 SCOPE OF FINANCIAL INSTRUMENTS

Scope of financial instruments excludes the following:

(a) Interests in subsidiaries, associates and joint ventures that are accounted for in accordance with Ind AS 110 *Consolidated Financial Statements*, Ind AS 27 *Separate Financial Statements* or Ind AS 28 *Investments in Associates and Joint Ventures*. However, in some cases, Ind AS 110, Ind AS 27 or Ind AS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in Ind AS 32 *Financial Instruments: Presentation*.

(b) Rights and obligations under leases to which Ind AS 116 Leases applies. However,

(i) finance lease receivables (i.e. net investments in finance leases) and operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of Ind AS 109;

© The Institute of Chartered Accountants of India

(ii) lease liabilities recognised by a lessee are subject to the derecognition requirements in paragraph 3.3.1 of Ind AS 109; and

(iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of Ind AS 109.

(c) employers' rights and obligations under employee benefit plans, to which Ind AS 19 *Employee Benefits* applies.

(d) rights and obligations arising under (i) an insurance contract as defined in Ind AS 117 Insurance Contracts, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) a contract that is within the scope of Ind AS 117 because it contains a discretionary participation feature.

- However, this Standard applies to a derivatives that are embedded in contracts within the scope of Ind AS 117 if the derivatives are not itself contracts within the scope of Ind AS 117.
- This standard applies to investment components that are separated from contracts within the scope of Ind AS 117, if Ind AS 117 requires such separation, unless the separated investment component is an investment contract with discretionary participation features within the scope of Ind AS 117.
- Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 117 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.
- This standard applies to an entity's rights and obligations that are financial instruments arising under credit card contracts, or similar contracts that provide credit or payment arrangements, that an entity issues that meet the definition of an insurance contract but which Ind AS 117 excludes from the scope of Ind AS 117. However, if, and only if, the insurance coverage is a contractual term of such a financial instrument, the entity shall separate that component and apply Ind AS 117 to it.
- This standard applies to an entity's rights and obligations that are financial instruments arising under insurance contracts that an entity issues that limit the

© The Institute of Chartered Accountants of India

compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract, if the entity elects, in accordance with Ind AS 117, to apply Ind AS 109 instead of Ind AS 117 to such contracts.

(e) Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.

(f) Loan commitments other than those loan commitments described below –

- loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
- loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).
- commitments to provide a loan at a below-market interest rate

However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.

(g) Financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102 *Share-based Payment* applies, except for contracts to buy non-financial items as described below.

(h) Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognised a provision in accordance with Ind AS 37.

(i) Rights and obligations within the scope of Ind AS 115 *Revenue from Contracts with Customers* that are financial instruments, except for those that Ind AS 115 specifies are accounted for in accordance with this Standard.

© The Institute of Chartered Accountants of India

Summary of the transaction outside the scope Financial Instruments:

Sl. No.	Particulars	Covered under Ind AS 109	Covered under Ind AS 32	Under Ind AS 107	Applicable Ind AS
1	Interest in subsidiaries (At Costs)	No	No	No	Ind AS 27
2	Interests in associates (At Costs)	No	No	No	Ind AS 27
3	Interest in joint ventures (At Costs)	No	No	No	Ind AS 27
4	Rights and obligations under leases	No	No	Yes	Ind AS 116
5	Employers' rights and obligations under employee benefit plans	No	No	No	Ind AS 19
6	Rights and obligations under an insurance contract	No	No	No	Ind AS 117
7	Forward contract arising within the scope of business combination	No	No	Yes	Ind AS 107
8	Loan commitment other than covered under Ind AS 109 and Ind AS 32	No	No	Yes	Ind AS 107
9	Shared based payments	No	No	No	Ind AS 102
10	Reimbursement right in respect of provision	No	No	Yes	Ind AS 37 and Ind AS 107
11	Rights and obligations under revenue for contracts with customers	No	No	Yes	Ind AS 115 and Ind AS 107

1.8 CONTRACTS TO BUY OR SELL NON-FINANCIAL ITEMS ('OWN USE EXEMPTION')

- Contracts to buy or sell non-financial items are outside the scope of 'financial instruments', except for the following:

  (a) Contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the

© The Institute of Chartered Accountants of India

contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

(b) A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments that are irrevocably designated as measured at fair value through profit or loss (even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements). This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard applying the scope exclusion in (a) above.

(c) A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, where such a contract was not entered into for the purpose of receipt or delivery of the non-financial item in accordance with entity's expected purchase, sale or usage requirements.

- There are various ways in which a contract to buy or sell non-financial items can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

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

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery 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.

© The Institute of Chartered Accountants of India

Example 4

ABC Ltd. enters into a contract to buy 100 tonnes of cocoa beans at 1,000 per tonne for delivery in 12 months. On the settlement date, the market price for cocoa beans is 1,500 per tonne. If the contract cannot be settled net in cash and this contract is entered for delivery of cocoa beans in line with ABC Ltd.'s expected purchase/ usage requirements, then own-use exemption applies.

In such case, the contract is considered to be an executory contract outside the scope of Ind AS 109 and hence shall not be accounted as a derivative.

© The Institute of Chartered Accountants of India