UNIT 3: FINANCIAL INSTRUMENTS: EQUITY AND FINANCIAL LIABILITIES

3.1 INTRODUCTION

Ind AS 32 lays down the accounting principles for classifying a financial instrument issued by an entity as either a financial liability or equity or both (a compound instrument). The classification of a financial instrument is governed by the substance of a contract and not its legal form.

As you would see in the following paragraphs, classification of a financial instrument into financial liability or equity or compound involves analysis of each component of a contract. Incorrect classification results in misstatement of financial statements and significantly affects the financial ratios that are derived therefrom.

3.2 DEFINITIONS – FINANCIAL LIABILITY AND EQUITY

It is important to read paragraphs 11 and 16 of Ind AS 32 together to identify the accounting principles that distinguish a financial liability instrument from an equity instrument.

Before we look at the two definitions in a comparative format, it is important to highlight here that the classification of a financial instrument under Ind AS 32 is done from the perspective of the issuer and not from the perspective of the holder.

Financial liability (Ind AS 32.11)	Equity (Ind AS 32.16)
A financial instrument that fulfils **either of (A) or (B)** below: ***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	A financial instrument that fulfils **both (A) and (B)** below: ***Condition (A)***: 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

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Condition (B): 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.	***Condition (B)***: An instrument that will or may be settled in the entity's own equity instruments and is: 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.

As can be seen from the table above, the two definitions are mirror images of each other. In the following paragraphs, we will discuss each of these aspects in detail.

Importance of the phrase "contract" and "contractual"

It is important to know that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing [Ind AS 32.13]. Liabilities that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities. Accounting for income taxes is dealt with in Ind AS 12. Similarly, constructive obligations, as defined in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets, do not arise from contracts and are not financial liabilities.

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. [Ind AS 32.AG11]

It should also be remembered that the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual obligation of the guarantor to pay the lender, if the borrower defaults [Ind AS 32.AG8].

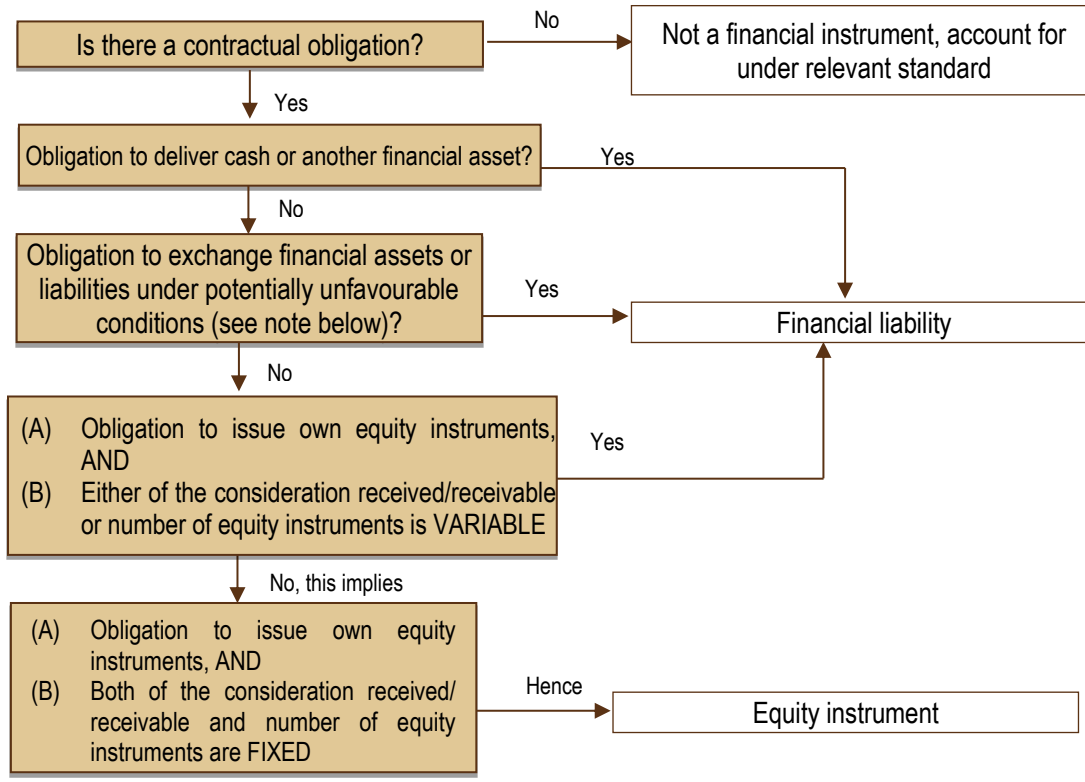
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Analysis of the definitions

The following points must be remembered in determination of classification of a financial instrument as a financial liability or equity:

- ***Evaluation of components***- it is not always that the entire instrument is either a financial liability or equity. The issuer makes this determination for each component part of a contract in accordance with 'substance' thereof and definitions given above [Ind AS 32.15].
- ***Contract is supreme*** - The evaluation of 'substance' does not override or contravene the contractual terms.
- ***Contract cannot override laws*** - The entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

The flowchart below summarises the distinction between the definitions of a financial liability and equity:



Note: Potential unfavourable conditions

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Example 1

PQR Ltd. issues a call option (i.e. an option to buy) to ABC Ltd. to subscribe to PQR Ltd.'s equity shares at a price of ₹ 100 per share. The call option is to be settled on a 'net' basis i.e. without physical delivery of shares. If at the balance sheet date, market value of equity share of PQR Ltd. is ₹ 110 per share, PQR Ltd. will be obliged to pay ₹ 10 to settle the option. Such a condition is potentially unfavourable to PQR Ltd. and hence ₹ 10 represents a financial liability for PQR Ltd.

3.3 OBLIGATION TO DELIVER CASH

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer (Ind AS 32.17).

There are very limited exceptions to this principle in the form of "puttable instruments" and "obligations arising on liquidation". We will discuss these exceptions in the subsequent paragraphs, "Puttable instruments and obligations arising on liquidation".

The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. [Ind AS 32.18(b)]

Subject to certain exceptions as mentioned above, if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. (Ind AS 32.19)

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. (Ind AS 32.20)

Illustration 1: Redeemable preference shares with mandatory dividend

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.

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Solution

This instrument provides for mandatory fixed dividend payments and redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the preference shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

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Illustration 2 : Redeemable debentures with discretionary dividend

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.

Solution

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.

The second component of interest payable is discretion of the issuer and hence will be classified as equity. This is also discussed in detailed in the compound financial instrument section (Also refer Illustration 27 in the subsequent section).

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Illustration 3: Perpetual loan with mandatory interest

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

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Illustration 4: Restriction on the ability of an entity to satisfy a contractual obligation

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?

Solution

Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

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Illustration 5: Optionally convertible redeemable preference shares

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

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In the section "Compound financial instruments", we will also analyse the other component – the conversion option with the holder and we will explain the nature of the instrument in its entirety.

Illustration 6: Settlement alternative is non-financial obligation

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 to the holder, whose value is estimated to be significantly higher than the cash settlement amount. Examine the nature of the financial instrument.

Solution

Such preference shares are financial liability because the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation.

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3.3.1 Puttable instruments and obligations arising on liquidation – Exceptions to classification as 'financial liability' for instruments settled in cash or another financial asset

Let us analyse this in the following two contexts:

A. Mutual funds and unit trusts, wherein the redemption amount is equal to a proportionate share in the net assets of the entity

B. Limited life entities like special purpose vehicles (SPV) for execution of an infrastructure project

First, let us look at one definition which is relevant for our discussion – "Puttable instrument" is a financial instrument that gives the holder:

- the right to put the instrument back to the issuer for cash or another financial asset, or
- is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

[The phrase "put back to the issuer" refers to redemption of the instrument. If the holder has a right, but not an obligation to require the issuer to redeem the instrument, it is referred to as "put option".]

As discussed above, financial instruments that contain an obligation of the issuer to deliver cash or another financial asset are classified as financial liabilities. As per this principle, the following shall be classified as financial liabilities:

- Puttable instruments (see context A above in Section 3.3.1), and
- Instruments that create an obligation only on liquidation of the entity (see context B above). Liquidation may be certain to occur and outside issuer's control or uncertain to occur and at the option of holder.

However, Ind AS 32 contains an exception whereby such instruments are classified as "equity", despite the fact that they otherwise meet all the conditions for "financial liability". This exception applies if **all** of the following conditions are fulfilled by the instrument (Ind AS 32.16A, 16B, 16C and 16D):

1. It **entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation**. In other words, the instrument should not entitle its holder to a higher or lower share of entity's net assets upon liquidation.

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The logic behind this requirement is that entitlement to a pro rata share of the entity's net assets on liquidation is equivalent to having a residual interest in the assets of an entity.

Illustration 7: Cap on amount payable on liquidation

ABC Ltd. has two classes of puttable shares – Class A shares and Class B shares. On liquidation, Class B shareholders are entitled to a pro rata share of the entity's residual assets up to a maximum of ₹ 10,000,000.

There is no limit to the rights of the Class A shareholders to share in the residual assets on liquidation. Examine the nature of the financial instrument.

Solution

The cap of ₹ 10,000,000 means that Class B shares do not have entitlement to a pro rata share of the residual assets of the entity on liquidation. They cannot therefore be classified as equity.

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2. It is in the class of instruments that is **subordinate to all other classes of instruments**, that is, in its present form, it has no priority over other claims to the entity's assets **on liquidation** (entity will need to assume liquidation on date of classification).

Illustration 8: Investment manager's share in a mutual fund

Mutual Fund X has an Investment Manager Y. At the inception of the fund, Y had invested a nominal or token amount in units of X. Such units rank last for repayment in the event of liquidation. Accordingly, they constitute the most subordinate class of instruments. Examine the nature of the financial instrument.

Solution

The units held by Y holders are classified as equity as they are most subordinate class of instruments and will be entitled to residual interest.

However, the units held by other unit holders are classified as financial liability as they are not the most subordinate class of instruments – they are entitled to pro rate share of net assets on liquidation, and their claim has a priority over claims of Y.

It may be noted that the most subordinate class of instruments may consist of two or more legally separate types of instruments.

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3 (a) In case of puttable instruments, all financial instruments in the most subordinate class have **identical features**: For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

Illustration 9: Differential voting rights

T Motors Ltd. has issued puttable ordinary shares and puttable 'A' ordinary shares whereby holders of ordinary shares are entitled to one vote per share whereas holders of 'A' ordinary shares are not entitled to any voting rights. The holders of two classes of shares are equally entitled to receive share in net assets upon liquidation. Examine whether the financial instrument will be classified as equity.

Solution

Neither of the two classes of puttable shares can be classified as equity, as they do not have identical features due to the difference in voting rights. It is not possible for T Motors Ltd. to achieve equity classification of the ordinary shares by designating them as being more subordinate than the 'A' ordinary shares, as this does not reflect the fact that the two classes of share are equally entitled to share in entity's residual assets on liquidation.

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(b) In contrast to the above, in case of instruments that impose on the entity an obligation to deliver pro rata share of net assets only on liquidation, all financial instruments in the most subordinate class have such identical contractual obligation.

4. In case of puttable instruments, apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, there are **no other contractual obligations**:

- to deliver cash or another financial asset, or
- to settle in variable number of entity's own equity instruments

In other words, there are no other features of the instrument which could satisfy the definition of "financial liability".

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Illustration 10: Conversion into a variable number of equity instruments

S Ltd. has issued a class of puttable ordinary shares to T Ltd. Besides the put option (which is consistent with other classes of ordinary shares), T Ltd. is also entitled to convert the class of ordinary shares held by it into equity instruments of S Ltd. whose number will vary as per the market value of S Ltd. Examine whether the financial instrument will be classified as equity.

Solution

The shares cannot qualify for equity classification in their entirety as in addition to the put option there is also a contractual obligation to settle the instrument in variable number of entity's own equity instruments.

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5. In case of puttable instruments, the **total expected cash flows attributable to the instrument** over the life of the instrument are based substantially on the:

   - profit or loss,
   - change in the recognised net assets or
   - change in the fair value of the recognised and unrecognised net assets

   of the entity over the life of the instrument (excluding any effects of the instrument).

   In other words, if the cash flows are attributable to any factors other than the three listed above, for example, an index, the puttable instrument will fail the equity classification.

6. The issuer must have no other financial instrument or contract that has:

   - total cash flows on same terms as (5) above, with
   - the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

   The intent behind this "anti-abuse" clause is to ensure that puttable instruments are not artificially structured to satisfy conditions (1) to (5) above and at the same time the holder of that puttable instrument also holds another financial instrument or has entered into another contract with the issuer whose cash flows indirectly restrict or fix the return on puttable instrument.

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However, "another financial instrument" held by or "another contract" entered into, by the holder of puttable instrument, in its capacity as non-owner of puttable instrument, does not affect the classification of the puttable instrument.

Illustration 11: Management fee contract between issuer and puttable instrument holder

P Ltd. has issued puttable ordinary shares to Q Ltd. Q Ltd. has also entered into an asset management contract with P Ltd. whereby Q Ltd. is entitled to 50% of the profit of P Ltd. Normal commercial terms for similar contracts will entitle the service provider to only 4%-6% of the net profits. Examine whether the financial instrument will be classified as equity.

Solution

The puttable ordinary shares cannot qualify for equity classification as (a) in addition to the put option, there is another contract between the issuer (P Ltd.) and holder of puttable instrument (Q Ltd.) whose cash flows are based substantially on profit or loss of issuer, (b) whose contractual terms are not similar to a contract between a non-instrument holder and issuer and (c) it has the effect of substantially restricting return on puttable ordinary shares.

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If the terms of asset management contract were assessed to be similar to terms of a contract between a non-instrument holder and the issuer, it would not have precluded equity classification for puttable shares, provided other conditions are met.

To summarise, the following conditions are required to be fulfilled in each of the two contexts set out at the beginning of this paragraphs:

- **Puttable instruments** (see context A above in Section 3.3.1) – conditions (1) to (6)
- **Instruments that create an obligation only on liquidation of the entity** (see context B above) – conditions (1) to (3) and condition (6).

3.3.1.1 Reclassification

- **Date of classification** of a financial instrument as an equity instrument in accordance with exceptions mentioned above – from the date when the instrument has all the features and meets the conditions set out above (Ind AS 32.16E).
- **Date of reclassification** of a financial instrument – from the date when the instrument ceases to have all the features or meet all the conditions set out above (Ind AS 32.16E).

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For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument that remain outstanding have all the features and meet all the conditions mentioned above, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

- **Accounting for reclassification (Ind AS 32.16F):**

Reclassification from	Reclassification to	Measurement	Recognition of difference in carrying amount and measurement of reclassified instrument
Financial liability	Equity	Carrying value at date of reclassification	-N.A.-
Equity	Financial liability	Fair value at date of reclassification	In equity

Illustration 12 : Issue of variable number of shares against issue of CCPS

A Ltd. issued compulsorily convertible preference shares (CCPS) at ₹ 100 each (₹ 10 face value + ₹ 90 premium per share) for ₹ 10,00,000. These are convertible into equity shares at the end of 10 years, where the number of equity shares to be issued shall be determined based on fair value per equity share to be determined at the time of conversion.

Evaluate if this is financial liability or equity? What if the conversion ratio was fixed at the time of issue of such preference shares?

Solution

1. As per Ind AS 32, non-derivative contracts which will be settled against issue of variable number of own equity shares meet the definition of financial liability.

   In this case, A Ltd. has issued CCPS which are convertible into variable number of shares. Hence, it is akin to use of own equity shares as currency for settlement of the liability of CCPS issued. Accordingly, it meets the definition of financial liability.

   Measurement –

   Initial measurement – This shall be measured at fair value on date of transaction. Since A Ltd shall give shares worth ₹ 10 lacs at the end of 10 years which is equal to the amount borrowed on day 1, the liability is recognised at fair value, determined by discounting future settlement of the borrowed amount. For difference arising on day 1 between amount

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borrowed and that recognised as liability using level 3 inputs, it is deferred and recognised on a systematic basis over the period of liability.

Subsequent measurement – Such liability shall be carried at fair value through profit or loss.

ii. Per Ind AS 109, a non-derivative contract that involves issue of fixed number of equity shares shall be classified as equity.

In this case, if the conversion of CCPS was into a fixed number of equity shares at the end of 10 years, then it meets the definition of equity and hence, shall be classified as 'equity instrument'.

An equity instrument is carried at cost and no further adjustments made to its carrying value after initial recognition.

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3.3.2 Obligation to purchase own equity instruments

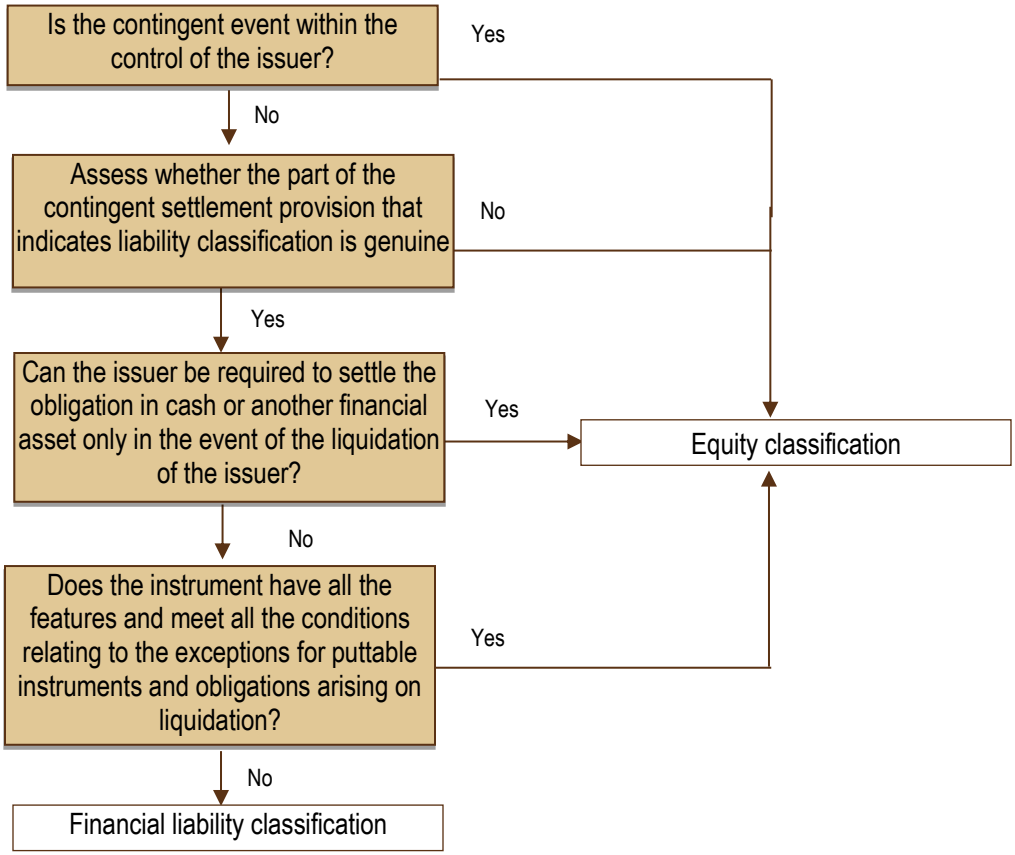
With the exception of the circumstances described above (paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32), a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. This is the case even for derivatives over equity instruments that meet the fixed for fixed test and would be equity in the absence of this rule. (Ind AS 32.23)

3.3.3 Contingent settlement provisions

A financial instrument may require an entity to deliver cash or another financial asset, or settle it in some other way that would require it to be classified as a financial liability, but only in the event of the occurrence or non-occurrence of some uncertain future event. The 'event' may be within the control of the issuer or of the holder, or beyond the control of both. These types of contractual arrangements are referred to as 'contingent settlement provisions'.

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The flowchart below explains the classification process for contingent settlement provisions:



3.3.4 Written put options over non-controlling interests

In consolidated financial statements, an entity presents non-controlling interests — ie the interests of other parties in the equity and income of its subsidiaries – in accordance with Ind AS 1 and Ind AS 110. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the

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holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole.

To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements. (Ind AS 32.AG29)

3.4 SETTLEMENT IN ENTITY'S OWN EQUITY INSTRUMENTS

A financial instrument is classified as a liability not just when there is an obligation to deliver cash or another financial asset. It is **sometimes** so classified even when the entity's obligation is to settle the instrument through delivery of its own equity instruments.

Let us evaluate two alternate situations for an instrument that is convertible at the option of the issuer:

Illustration 13: Conversion into a number of equity instruments equivalent to a fixed value

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 is:

$$\frac{100 \text{ crores } X \ (1+10\%)^{5}}{\text{Fair value on date of conversion}}$$

Examine the nature of the financial instrument.

Solution

Such a contract is a financial liability of the entity even though the entity can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. The underlying thought behind this conclusion is that the entity is using its own equity instruments 'as currency'.

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Illustration 14: Conversion into a fixed number of equity instruments

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.

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Solution

This contract is an equity instrument because changes in the fair value of equity shares arising from market related factors do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered.

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From the above two situations, we can conclude as below:

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. **If an entity has a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation, such a contract is a financial liability**. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). (Ind AS 32.21). The number of equity instruments to be delivered could vary as a result of entity's own share price. [Ind AS 32.AG27(d)]

- **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.** (Ind AS 32.22)

  The above requirements are summarised in the table below:

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

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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

The principle at ***serial number 2 in table above*** is also called **"fixed for fixed" test** i.e. fixed amount of cash or other financial asset for fixed number of own equity instruments.

Another point to note is a fine distinction highlighted in the definition of financial liability and equity, as mentioned in the paragraph "Definitions – financial liability and equity". Being mirror images of each other.

Illustration 15: Written option for a fixed or variable number of equity instruments

ST Ltd. purchases an option from AT Ltd. entitling the holder to subscribe to fixed number of equity shares of issuer at a fixed exercise price of ₹ 50 per share at any time during a period of 3 months. Holder paid an initial premium of ₹ 2 per option. Examine whether the financial instrument will be classified as equity.

Solution

For the issuer AT Ltd., this option is an equity instrument as it will be settled by the exchange of a fixed amount of cash for a fixed number of its own equity instruments.

If, on the other hand, if the exercise price of the option was variable, say benchmarked to an index or a variable, the written option will be classified as a "financial liability" in the books of the issuer, AT Ltd.

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For discussion on derivative instruments, refer Unit 4: Derivatives and Embedded derivatives.

In the above illustration, if the instrument is classified as "equity instrument", any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. It must also be noted that changes in the fair value of an equity instrument are not recognised in the financial statements. (Ind AS 32.22)

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On the contrary, if the derivative instrument (i.e. the written option) is classified as "financial liability", any consideration received is measured initially at fair value and subsequently also at fair value, with fair value changes recognised in profit or loss. ***For detailed discussion on measurement of financial liabilities, refer Unit 2***.

The chart below summarises the discussion above:

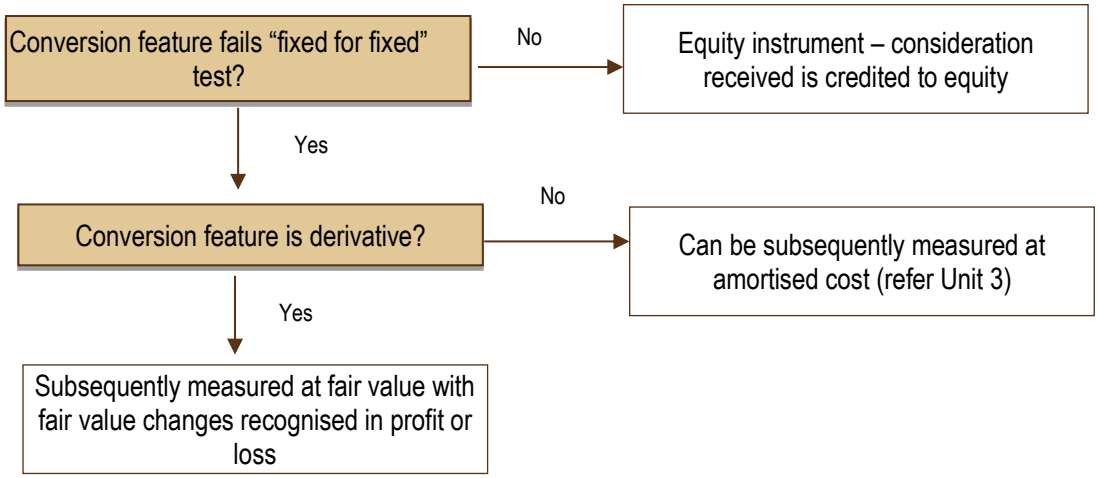


Illustration 16: Written option with multiple exercise prices

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.

Solution

As the contract will be settled by delivery of fixed number of instruments for a variable amount of cash, it is a financial liability.

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Illustration 17: Share swap arrangements

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.

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Solution

Such arrangements will not meet the condition for classification as "equity instrument" since the contract will be settled by delivery of fixed number of Acquirer Ltd.'s own equity instruments against a variable amount of cash i.e. market value of Target Ltd.'s equity shares.

Such a contract will likely result in a derivative liability or asset for both the parties.

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Illustration 18: Conversion ratio changes with time

On 1 January 20X1, NKT Ltd. subscribes to convertible preference shares of VT Ltd. The conversion ratio varies as below:

Conversion upto 31 March 20X1: 1 equity share of VT Ltd. for each preference share held

Conversion upto 30 June 20X1: 1.5 equity share of VT Ltd. for each preference share held

Conversion upto 31 December 20X1: 2 equity share of VT Ltd. for each preference share held.

Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, VT Ltd. The conversion ratio doesn't change corresponding to any underlying variable, it only varies in response to passage of time which is a certain event and hence fixed.

*****

Illustration 19: Conversion ratio changes to protect rights of convertible instrument holders

On 1 January 20X1, HT Ltd. subscribes to convertible preference shares of RT Ltd. The preference shares are convertible in the ratio of 1:1.

The terms of the instrument entitle HT Ltd. to proportionately more equity shares of RT Ltd. in case of a stock split or bonus issue. Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, RT Ltd. The variability in the conversion ratio is only to protect the rights of the holder of convertible instrument vis-à-vis other equity shareholders.

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The conversion was always intended to be in a fixed ratio and hence the holder is exposed to the change in equity value. The variability is brought in to maintain holder's exposure in line with other holders.

*****

Illustration 20: Conversion ratio changes if issuer subsequently issues shares to others at a lower price

On 1 January 20X1, PG Ltd. subscribes to convertible preference shares of BG Ltd. at ₹ 100 per preference share. The preference shares are convertible in the ratio of 10:1 i.e. 10 equity shares for each preference share held. On a fully diluted basis, PG Ltd. is entitled to 30% stake in BG Ltd.

If subsequent to the issuance of these convertible preference shares, BG Ltd. issues any equity instruments at a price lower than ₹ 10 per share, conversion ratio will be changed to compensate PG Ltd. for dilution in its stake below the expected dilution at a price of ₹ 10 per share. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, BG Ltd. The variability in the conversion ratio underwrites the return on preference shares and not just protects the rights of convertible instrument holders vis-à-vis equity shareholders.

*****

Illustration 21: Conversion ratio is variable in a narrow range

On 1 January 20X1, NG Ltd. subscribes to convertible preference shares of AG Ltd. at ₹ 100 per preference share. On a fully diluted basis, NG Ltd. is entitled to 30% stake in AG Ltd.

The preference shares are convertible at fair value, subject to, NG Ltd.'s stake not going below 15% and not going above 40%. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, AG Ltd. The variability in the conversion ratio underwrites the return on preference shares to an extent and also restricts that return. The preference shareholder is not entitled to residual net assets of the issuer.

In certain situations, an instrument is convertible only at the option of issuer. While such instruments provide the issuer with an unconditional right to avoid payment of cash, it is important

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to understand the economic substance of the option. It is also very important to determine whether the option is exercised by the issuer or by shareholders acting in their capacity as instrument holders.

For example, if the convertible instrument is held by the equity shareholders of the issuer and the conversion requires unanimous consent of all the shareholders, it would be inappropriate to consider that the issuer has an unconditional right to avoid payment of cash. In this situation, it would be more relevant to consider the rights of the instrument holders in their capacity as equity shareholders of the issuer.

*****

Illustration 22: Conversion ratio changes under independent scenarios

On 1 January 20X1, STAL Ltd. subscribes to convertible preference shares of ATAL Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests in the issuer within one year

Convertible 1.5:1: if a prospectus filing is successfully completed within 2 years

Convertible 2:1: if a binding agreement for sale of majority stake by equity shareholders is entered into within 3 years

Convertible 3:1: if none of these events occur in 3 years' time.

Examine whether the financial instrument will be classified as equity.

Solution

In this case the four events can be viewed as discrete because the achievement of each one of these can occur independently of the other (as they relate to different periods). The arrangement can therefore be considered to be economically equivalent to four separate contracts. The price per share and the amount of shares to be issued is fixed in each of these discrete periods, with each event relating to a different year and therefore a separate risk. The "fixed for fixed" test is therefore met.

The instrument is therefore classified as "equity instrument".

*****

Illustration 23: Conversion ratio changes under inter-dependent scenarios

On 1 January 20X1, RHT Ltd. subscribes to convertible preference shares of RDT Ltd.

The preference shares are convertible as below:

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Convertible 1:1 if another strategic investor invests at an enterprise valuation (EV) of USD 100 million.

Convertible 1.5:1: if another strategic investor invests at EV of USD 150 million

Convertible 2:1: if another strategic investor invests at EV of USD 200 million

Convertible 3:1: if no strategic investment is made within a period of 3 years

Examine the nature of the financial instrument.

Solution

The four events are interdependent because the second event cannot be met without also meeting the first event, and the third event cannot be met unless the first two are met.

Therefore, this contract should be treated as a single instrument when applying the "fixed for fixed" test. The test is then failed because the number of shares to be exchanged for cash are variable.

*****

3.4.1 Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled, it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument. (Ind AS 32.26)

For instance - a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash is a financial liability.

3.4.2 Settlement by delivery of instruments that meet conditions for exceptions to classification as financial liability

If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are:

- puttable financial instruments with all the features and meeting the conditions described in paragraphs 16A and 16B of Ind AS 32 (as discussed above), or
- 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 with all the features and meeting the conditions described in paragraphs 16C and 16D of Ind AS 32 (as discussed above), the contract is a financial asset or a financial liability.

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This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset. (Ind AS 32.22A)

3.4.3 Rights issues, options or warrants to acquire entity's own equity instruments for any currency

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. (Ind AS 32.11).

Carve out from IFRS: Equity conversion option embedded in a foreign currency convertible bond

Ind AS 32 considers the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency.

As per IFRS

As per accounting treatment prescribed under IAS 32, equity conversion option in case of foreign currency denominated convertible bonds is considered a derivative liability which is embedded in the bond. Gains or losses arising on account of change in fair value of the derivative need to be recognised in the statement of profit and loss as per IAS 32.

Carve out

In Ind AS 32, an exception has been included to the definition of 'financial liability' in paragraph 11 (b) (ii), whereby conversion option in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments is classified as an equity instrument if the exercise price is fixed in any currency.

Reasons

This treatment as per IAS 32 is not appropriate in instruments, such as, FCCBs since the number of shares convertible on the exercise of the option remains fixed and the amount at which the option is to be exercised in terms of foreign currency is also fixed; merely the difference in the currency should not affect the nature of derivative, i.e., the option. Further, the fair value of the option is based on the fair value of the share prices of the company. If there is decrease in the share price, the fair value of derivative liability would also decrease which would result in

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recognition of gain in the statement of profit and loss. This would bring unintended volatility in the statement of profit and loss due to volatility in share prices. This will also not give a true and fair view of the liability as in this situation, when the share prices fall, the option will not be exercised. However, it has been considered that if such option is classified as equity, fair value changes would not be required to be recognised. Accordingly, the exception has been made in definition of financial liability in Ind AS 32.

Let's understand this carve-out using an illustration:

Illustration 24: Foreign currency convertible bond

Entity A issues a bond with face value of USD 100 and carrying a fixed coupon rate of 6% p.a. Each bond is convertible into 1,000 equity shares of the issuer. Examine the nature of the financial instrument.

Solution

While the number of equity shares is fixed, the amount of cash is not. The variability in cash arises on account of fluctuation in exchange rate of INR-USD. Such a foreign currency convertible bond (FCCB) will qualify the definition of "financial liability".

However, Ind AS 32.11 provides, "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." Accordingly, FCCB will be treated as an "equity instrument".

But one cannot ignore the fixed coupon rate of 6% which is an obligation to deliver cash and therefore, financial liability. Accordingly, FCCBs under Ind AS 32 shall be classified as compound financial instruments if the interest liability is to be delivered in cash or shares in lieu of cash.

*****

3.5 COMPOUND FINANCIAL INSTRUMENTS

So far we have discussed two broad aspects of classification:

- Obligations to deliver cash – generally, instruments with such obligations are classified as "financial liability"
- Settlement in own equity instruments – generally, instruments with such provisions are classified as "equity"

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There are several exceptions to the general principles stated above, as we have seen in several illustrations discussed so far.

Let us now study those instruments which have features of both a financial liability and equity instrument. Such instruments are called "compound financial instruments". This topic is aimed at discussing the accounting treatment of such instruments and practical complexities that are arise due to issuance of such instruments.

The following illustrations demonstrate the identification of separate components of a financial instrument and determining whether it is a compound financial instrument.

Illustration 25: Redeemable debentures with discretionary dividend (continued from Illustration 2)

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.

Solution

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.

The other component, discretionary interest is an equity feature because issuer can avoid payment of cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 26: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

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The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

The other component, perpetual principal, is an equity feature because issuer is not required to pay cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 27: Optionally convertible redeemable preference shares (continued from Illustration 5)

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

The other component, conversion option with the holder, is an equity feature if the "fixed for fixed" test is satisfied. If the conversion option does not fulfil that test, say, because the conversion ratio varies in response to an underlying variable, it is a derivative liability.

Such an instrument is called a "hybrid instrument".

*****

3.5.1 Split accounting for compound financial instruments

Ind AS 109 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components:

- the equity component is assigned the residual amount i.e.
  - fair value of the instrument as a whole, *less*
  - the amount separately determined for the liability component.

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- The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.
- No gain or loss arises from initially recognising the components of the instrument separately.

(Ind AS 32.31)

In Illustrations 26 and 27 above, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and/or principal, ignoring the possibility of exercise of the conversion option, if any. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by perpetual principal in Illustration 26 and conversion option in Illustration 27 is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

Illustration 28: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder) for ₹ 12 lakhs. The loan is perpetual and entitles the holder to fixed interest of 8% p.a. The rate of interest commensurate with credit risk profile of the issuer is 12% p.a. Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of interest payable in perpetuity (₹ 96,000 discounted at 12%) = ₹ 800,000

Therefore, equity component = fair value of compound instrument, say, ₹ 1,200,000 less financial liability component i.e. ₹ 800,000 = ₹ 400,000.

In subsequent years, the profit and loss account is charged with interest of 12% on the debt instrument.

*****

Illustration 29: Optionally convertible redeemable preference shares (continued from Illustration 27)

On 1 July 20X1, D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the

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preference shares are redeemed at the end of 3 years. The preference shares carry a fixed coupon of 6% p.a. and is payable every year. The prevailing market rate for similar preference shares, without the conversion feature, is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 9% for 3 years) = ₹ 772,183

Present value of interest payable in arrears for 3 years (₹ 60,000 discounted at 9% for each of 3 years) = ₹ 151,878

Total financial liability = ₹ 924,061

Therefore, equity component = fair value of compound instrument, say, ₹ 1,000,000 less financial liability component i.e. ₹ 924,061 = ₹ 75,939.

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument.

*****

3.5.2 Separation of non-equity embedded derivatives

Sometimes, the issuer also has the option to early redeem the instrument mentioned in Illustration 29. Such an option is issuer's call option. This call option is considered an embedded derivative which is a financial liability. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. (Ind AS 32.31)

Illustration 30: Optionally convertible preference shares with issuer's redemption option

D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a coupon of RBI base rate plus 1% p.a. and is payable at the end of every year.

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The prevailing market rate for similar preference shares, without the conversion feature or issuer's redemption option, is RBI base rate plus 4% p.a. On the date of contract, RBI base rate is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 13% for 3 years) = ₹ 6,93,050

Present value of interest payable in arrears for 3 years (₹ 100,000 discounted at 13% for each of 3 years) = ₹ 2,36,115

Paragraph AG 31 of Ind AS 32 states that a common form of compound financial instruments is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivatives features.

The liability component = Present value of principal + Present value of Interest

= ₹ 6,93,050 + ₹ 2,36,115 = ₹ 9,29,165

Equity Component = ₹ 10,00,000 – ₹ 9,29,165 = ₹ 70,835

*****

Illustration 31: Instrument convertible only at the option of issuer

XYZ Ltd. issues optionally convertible debentures with the following terms:

The debentures carry interest at the rate of 7% p.a.

Issuer has option to either:

Convert the instrument into a fixed number of its own shares at any time, or redeem the instrument in cash at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted.

The holder has no conversion or redemption options.

Debentures have a tenor of 12 years and, if not converted or redeemed earlier, will be repaid in cash at maturity, including accrued interest, if any.

Examine the nature of the financial instrument.

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Solution

The issuer has the ability to convert the debentures into a fixed number of its own shares at any time. The issuer, therefore, has the ability to avoid making a cash payment or settling the debentures in a variable number of its own shares. Therefore, such a financial instrument is likely to be classified as equity.

However, it must be noted that mere existence of a right to avoid payment of cash is not conclusive. The instrument is to be accounted for as per its substance and hence it needs to be seen whether the conversion option is substantive.

In this particular situation, the issuer will need to determine whether it is favourable to exercise the conversion option or redemption option. In case of latter, the instrument will be classified as a financial liability (a hybrid instrument, whose measurement is dealt with in a subsequent section).

Practical situations do arise wherein the issuer has an option or obligation to issue own equity instruments only in particular circumstances i.e. the instrument is contingently convertible.

*****

3.5.3 Conversion or early settlement of compound financial instruments

3.5.3.1 Conversion

Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction. (Ind AS 32.30)

On conversion of a convertible instrument at maturity, the entity:

- derecognises the liability component and
- recognises it as equity.
- original equity component remains as equity (although it may be transferred from one line item within equity to another).
- there is no gain or loss on conversion at maturity.

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3.5.3.2 Early settlement

When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued. (Ind AS 32.AG33)

In other words, the issuer:

- starts by **allocating the settlement price to the remaining liability** i.e. it determines the fair value of the remaining liability using a discount rate that is based on circumstances at the settlement date (this rate may differ from the rate used for the original allocation), and
- allocates the residual settlement amount to the equity component.

As per Ind AS 32.AG34, once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

(a) the amount of gain or loss relating to the liability component is recognised in profit or loss; and

(b) the amount of consideration relating to the equity component is recognised in equity.

Illustration 32: Optionally convertible redeemable preference shares (continued from Illustration 29)

The amortisation schedule of the instrument is set out below:

Dates	Cash flows	Finance cost at effective interest rate	Liability	Equity
1July 20X1	1,000,000	-	9,24,061	75,939
30 June 20X2	(60,000)	83,165	9,47,226	75,939
30 June 20X3	(60,000)	85,250	9,72,476	75,939
30 June 20X4	(10,60,000)	87,524	-	75,939

Assume that D Ltd. has an early redemption option to prepay the instrument at ₹ 11 lakhs and on 30 June 20X3, it exercises that option. At 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%. Calculate the value of the liability and equity components.

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Solution

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

Particulars	Amount (₹)
Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year)	9,52,381
Present value of interest payable (₹ 60,000 discounted at 5% for one year)	57,142
Total liability component	10,09,523
Consideration paid	11,00,000
Residual – equity component	90,477

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is recognised in equity.

*****

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date.

The difference, at the date the terms are amended, between:

- the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and
- the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

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3.6 TREASURY SHARES

If an entity reacquires its own equity instruments:

- Consideration paid for those instruments ('treasury shares') shall be deducted from equity. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.
- Consideration received shall be recognised directly in equity.
- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments

In the consolidated financial statements, consideration for treasury shares acquired and held by other members of the consolidated group, is deducted from equity.

It may be noted that when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

3.7 INTEREST, DIVIDENDS, LOSSES AND GAINS

The accounting principles related to transactions arising consequent to recognition of financial instruments are summarised below (Ind AS 32.35-41):

- The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.
  - Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.
  - Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.
- **Transaction costs:**
  - Equity transaction – accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would

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have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

- ➢ Compound financial instrument – allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.

- ♦ Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12 Income Taxes
- ♦ Changes in the fair value of an equity instrument are not recognised in the financial statements.
- ♦ **Presentation:**
  - ➢ The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately in accordance with Ind AS 1.
  - ➢ Dividends classified as an expense may be presented in the Statement of Profit and Loss either with interest on other liabilities or as a separate item.
  - ➢ Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.

3.8 OFFSETTING A FINANCIAL ASSET AND A FINANCIAL LIABILITY

In many situations, an entity has the right to receive or pay a single net amount in relation to two or more separate financial instruments and intends to do so as well.

As per Ind AS 32.42 and Ind AS 32.AG38A, a financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

(a) currently has a **legally enforceable right to set off** the recognised amounts – this means that the right of set off:

i. must not be contingent on a future event; and

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ii. must be legally enforceable in the normal course of business, in the event of default and in the event of insolvency or bankruptcy of the entity and all of the counterparties.

(b) **intends** either to settle on a net basis, or to realise the asset and settle the liability simultaneously - If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle.

Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the balance sheet but also may result in recognition of a gain or loss. (Ind AS 32.44).

A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. (Ind AS 32.45).

The conditions set out above are generally not satisfied and offsetting is usually inappropriate when (Ind AS 32.49):

(a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument') - For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt:

i. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions

ii. Each may be transferred or settled separately.

iii. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed.

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Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's balance sheet on a net basis unless they meet the criteria for offsetting.

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counter parties;

(c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

(d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

(e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

QUICK RECAP

- Classification as a financial liability or as equity depends on the substance of a financial instrument rather than its legal form. The substance depends on the instrument's contractual rights and obligations.
- Liability classification - a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset or own equity shares in lieu of cash to the instrument holder
- There are certain rule-based exceptions to the basic principle for classification of an instrument as financial liability – puttable instruments and obligations arising only on liquidation
- Financial instrument containing a contingent settlement provision, under which the instrument would be classified as a financial liability on the occurrence or non-occurrence of some uncertain future event beyond the control of both the issuer and the holder – usually classified as a financial liability unless the part of the contingent settlement provision that indicates liability classification is not genuine; or the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer
- Instruments which may or will be settled in an entity's own equity instruments – apply "fixed for fixed" test

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- Instruments with both equity and liability features are compound instruments – equity and liability components are accounted for separately ('split accounting')
- Split accounting involves first calculating the fair value of the liability component. The equity component is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole
- Subsequent changes in the value of the equity instruments are not recognised in the financial statements.
- The accounting implication of classification of a financial instrument as a financial liability or equity is given in table below:

Accounting aspect	Financial liability	Equity instrument
Re-measurement standard	Ind AS 109	Generally, not re-measured after initial measurement
Recognition of interest, dividends, losses and gains	Profit or loss	Retained earnings
Recognition of transaction costs	Included in calculation of effective interest rate and amortised over expected life of the instrument	Deduction from equity

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