IND AS 32- Financial Instruments: Presentation

MAY 19, 2023

Agenda

- IND AS covering financial instruments
- Scope of IND AS 32
- Definition of Financial Instruments
- Financial assets
- Financial liabilities
- Equity vs liability
- Compound Financial Instruments
- Classification and reclassifications
- Offsetting

IND AS related to financial instruments

IND AS 109

a) Recognition and De recognition of Financial Instruments
b) Classification & reclassification of financial instruments
c) Impairment of financial instruments
d) Derivatives
e) Hedge Accounting

IND AS 32

Presentation and offsetting

IND AS 107

Disclosure

Not applicable for

a) Interest in subsidiary, associate and Joint ventures
b) Contracts and obligations under share based payments
c) Employer’s rights & obligations under employee benefit plan
d) Financial instruments outside the scope of IND AS 104

Financial Instruments

- Financial asset
- Financial Liability
- Equity instruments

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 may be 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.

Financial Asset

Financial Assets

Cash	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	A contract that will or may be settled in the entity's own equity instruments and is: i. a **non-derivative** for which the entity is or may be obliged to receive a **variable** number of the entity's own equity instruments; or ii. a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a **fixed** number of the entity's own equity instruments
An equity instrument of another entity;		

Financial Asset

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.
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

Financial Asset

S. No.	Particulars	Whether FA or not	Remarks
			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.

Financial Liability

Financial Liability

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 unfavorable to the entity; or

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

i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

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.

Financial Liability

Evaluate the financial Liability.

S.No.	Particulars	Whether FL or not	Remarks
1	Loans payable or bank loan	FL	• Contractual obligation to pay cash / bank.
2	Trade and other payables	FL	• Contractual obligation to pay cash / bank
3	Bills payable / acceptance	FL	• Contractual obligation to pay cash / bank
4	Deposits received	FL	• Contractual obligation to pay cash / bank
5	Mandatory redeemable preferences shares	FL	Contractual obligation to pay cash / bank
6	Financial guarantee given	FL	• Contractual obligation to pay cash, due to the occurrence of certain events.

Financial Liability – Contract for exchange on unfavourable 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.

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'.

Financial Liability – Contract for exchange on unfavourable conditions

Details	Conclusion
A limited issues preference shares to B limited. These are redeemable at the end of 10 years from the date of issue and entitle the holder to cumulative dividend of 15% p.a. The rate is commensurate with risk	a) Fixed dividend is there b) Redemption is at fixed amount and fixed date c) Obligation to pay cannot be avoided Conditions met are of financial liability
A limited issues debentures to B limited. These are redeemable at the end of 10 years from the date of issue and interest of 15% p.a. is payable at discretion of the issuer. The rate is commensurate with risk.	a) Interest payment is discretionary b) Redemption is at fixed amount and fixed date c) Repayment of principal cannot be avoided Hence principal is financial liability and interest is equity
A limited takes loan from C limited, loan is perpetual entitles the holder to fixed interest of 8% p.a.	a) Mandatory interest at fixed date and fixed amount b) Perpetual nature of principal Nature is of financial liability for interest and principal is of equity
Does the lack of access to foreign currency or need to obtain an approval from a regulatory authority will lead to contractual obligation	Lack of access doesn't negate the entity's contractual obligation or holders contractual right in the instrument

Financial Liability – Contract for exchange on unfavourable conditions

Details	Conclusion
D limited issues preference shares to G limited, the holder has an option to convert preference shares to equity anytime upto a period of 10 years. If the option is not exercised preference shares are redeemed at the end of 10 years.	a) Covertion option is with holder b) Contractual obligation is conditional upon holder exercising its right to redeem There is an obligation to repay when exercised by holder then its financial liability
Company issues preference shares redeemable at the end of 5 years from the date of issue. There is 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	It's a financial liability as obligation to transfer cash or other assets is unavoidable

Financial Liability – Perpetual instrument with coupon step up and dividend pusher

Issuer A issues a perpetual instrument with the following terms.

- CU100 million notional with annual 8 percent interest payments for 8 years. Issuer A has a call option embedded in the instrument that allows the instruments to be repurchased at the end of Year 8, and every year after, for CU100 million.
- If the instrument is not called by the issuer at the end of Year 8, the interest on the instrument increases to 14 percent per annum (commonly referred to as a 'step-up' feature).
- The interest payments before and after the call date are only payable if Issuer A pays a dividend on its ordinary shares which are classified wholly as equity (commonly referred to as a 'dividend pusher').
- Issuer A has consistently chosen to pay dividends on its ordinary shares. Issuer A's cost of borrowing for a similar debt instrument when the perpetual instrument is issued is for approximately 8 percent.

Issuer A does not have an indirect or a direct obligation to pay cash or other financial asset in respect of the perpetual instrument. The instrument is therefore classified wholly as equity.

Financial Liability – Perpetual instrument with coupon step up and dividend pusher

Issuer A has no obligation to pay interest because it can always avoid paying interest by exercising its discretion and not paying dividends on its ordinary shares. Issuer A has no obligation to exercise its right to call the instrument at the end of Year 8 because the call right is an option and Issuer A could always choose not to exercise that right. Because the instrument is perpetual, there is no redemption date and, therefore, the instrument does not contain any contractual obligation to pay cash or another financial asset.

In determining the substance of the contractual arrangement, an entity must assess whether the terms of the instrument provide the issuer with discretion as to whether to deliver cash or another financial asset. In the circumstances described, Issuer A has discretion as to whether or not it wishes to pay an ordinary dividend. Even though it may be highly likely that Issuer A will choose to pay ordinary dividends and, as a result, will be required to pay interest under the perpetual instrument, the high likelihood is of itself not sufficient for the instrument to be classified as a financial liability. Similarly, although it may be very likely that Issuer A will pay interest on the perpetual instrument and will exercise its call option at the end of Year 8 (thus making the instrument economically equivalent to an 8-year loan), this of itself is not sufficient for the instrument to be classified as a financial liability.

Equity instruments

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:

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

Equity instruments

(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.

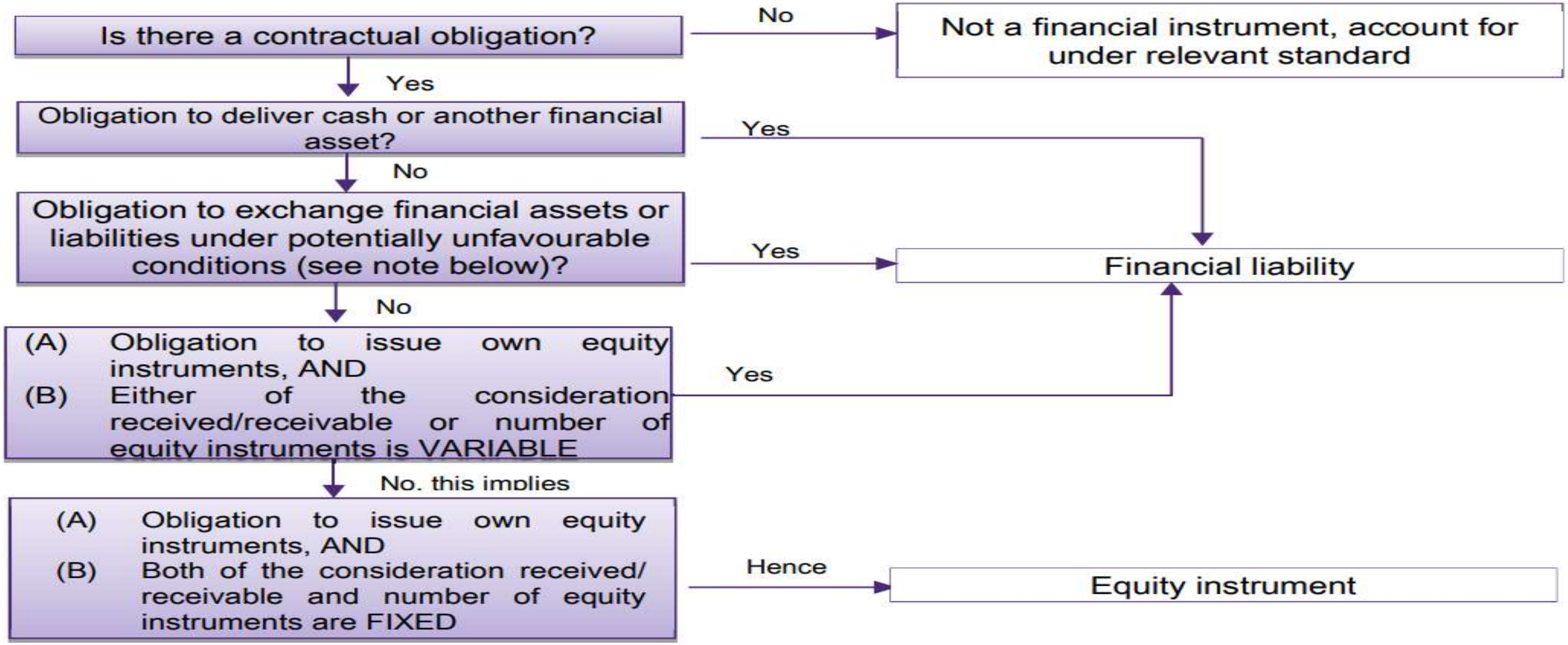
A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

Equity

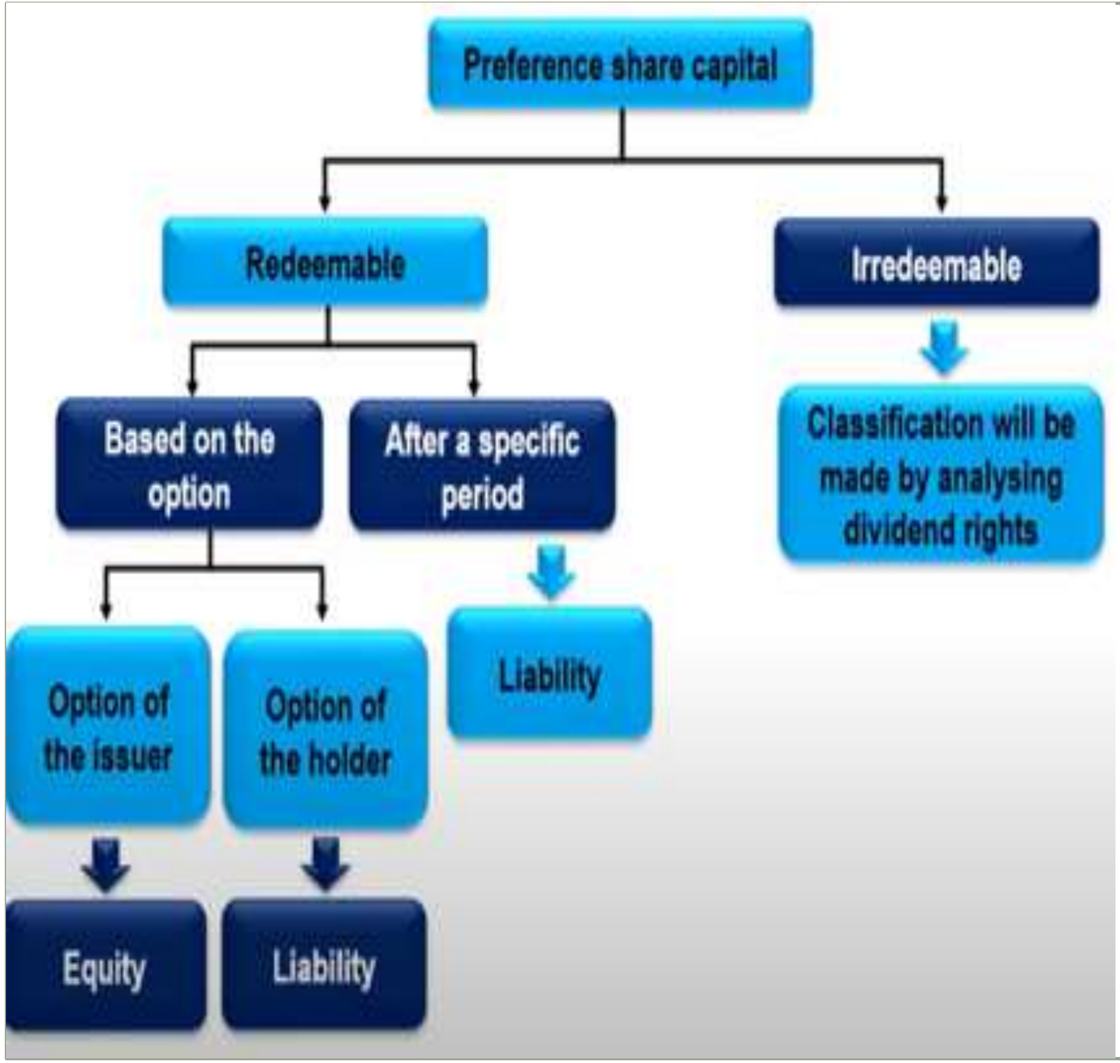
- Equity instruments issued
- Warrants to issue fixed number of shares at fixed price against each warrant
- Other instruments convertible into fixed number of equity shares, etc.

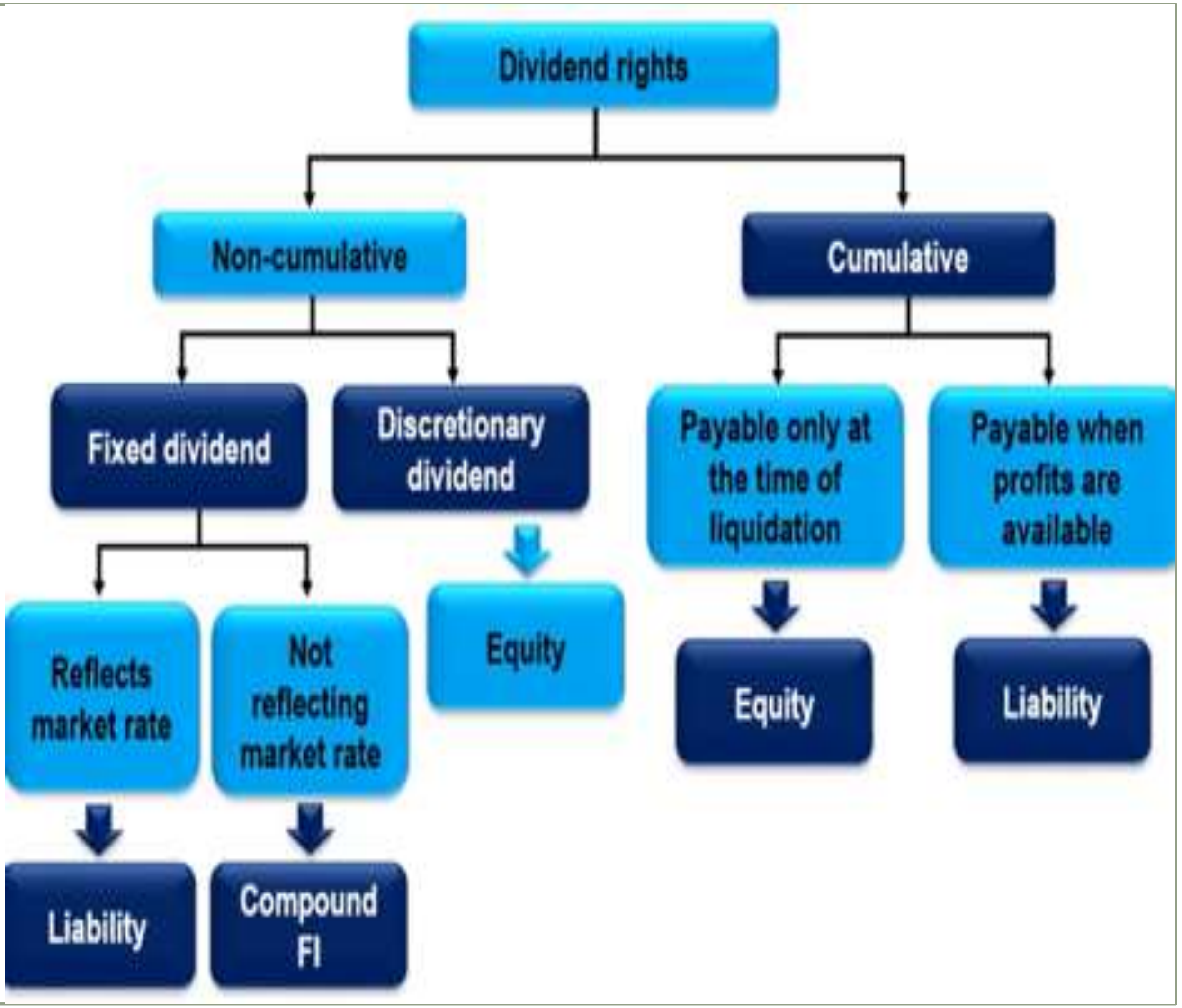
Puttable Instruments

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



Preference Shares





Examples

Details	Conclusion
Company issued irredeemable preference shares with face value of INR 10 and premium of INR 90. The share carries a dividend of 8% p.a however dividend is paid only when Company declares dividend on equity shares	a) No contractual obligation to pay cash b) Face value is not redeemable c) Dividend is discretionary Conditions met are of equity instruments
Company invests in CCPS of its subsidiary at 1000 each [10 face value and 990 premium]. Under the terms of the instrument, each CCPS is compulsorily convertible into one equity of subsidiary at the end of 5 years. CCPS carries a dividend of 12% payable at discretion of the subsidiary	a) Conversion ratio is fixed to fixed b) Non cumulative dividends c) No obligation to pay cash Conditions met are of equity instruments
Company borrows INR 10 lakhs, enters into an agreement with lender for settlement of loan against issue of certain number of equity instruments whose value equals 10 lakhs. Number of shares to be issued is based on fair value of the shares at a future date upon settlement of the contract	a) Obligation to issue variable number of equity shares equal to INR 10 lakhs b) Hence shares issued are used as currency for purpose of settlement of an amount payable Conditions met are of financial liability

Comparison of financial asset, financial liability and equity

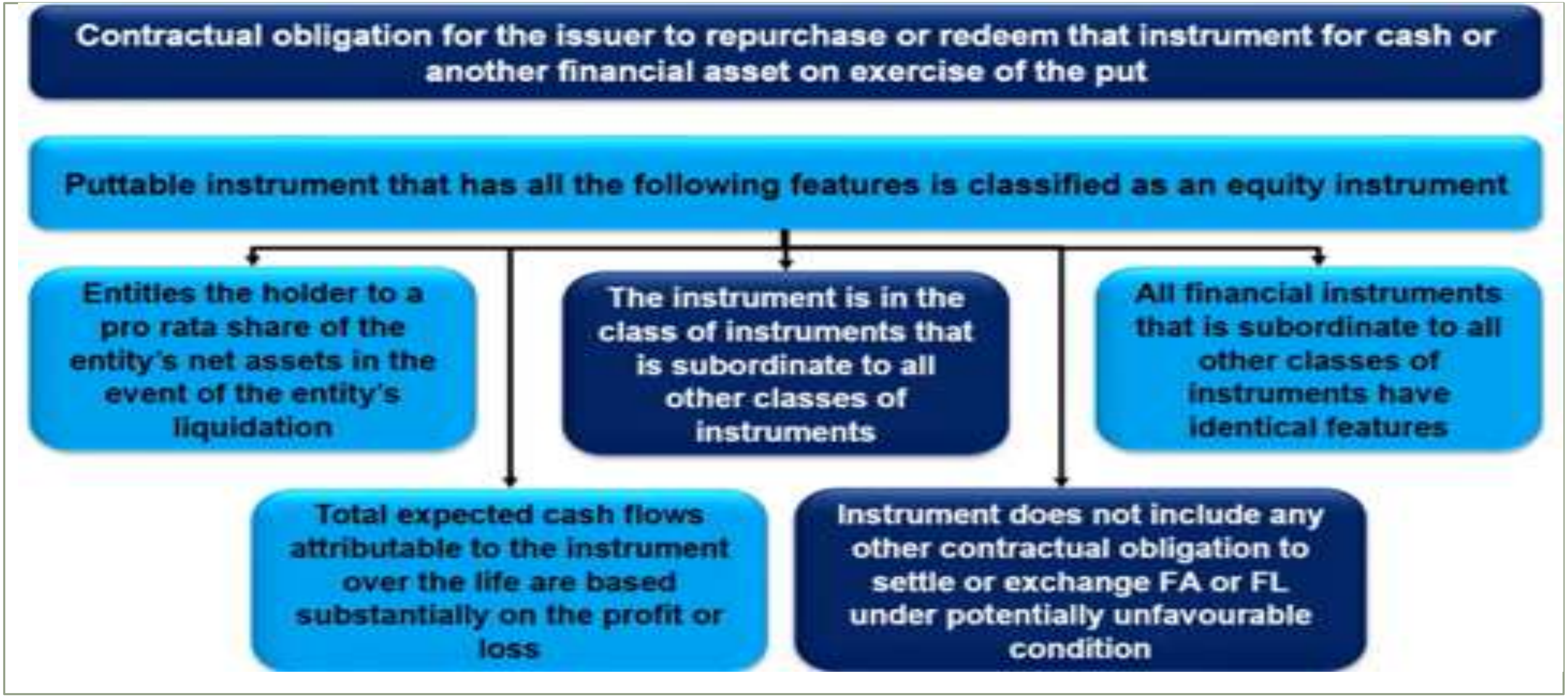
Sl. No.	Financial Assets	Financial liabilities	Equity
1	Cash	-	-
2	An equity instrument of another entity.	-	-
3.	**A contractual right** To receive cash or another financial asset from another entity Or	**A contractual obligation** To deliver cash or another financial asset to another entity Or	**No 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 under conditions that are **potentially unfavourable** to the issuer.
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).**

Transactions outside the scope of financial instruments

Summary of the transaction outside the scope Financial Instruments:

Sl. No.	Particulars	Covered under Ind AS 109	Covered under Ind AS 32	Applicable Ind AS
1	Interest in subsidiaries (At Costs)	No	No	Ind AS 27
2	Interests in associates (At Costs)	No	No	Ind AS 27
3	Interest in joint ventures (At Costs)	No	No	Ind AS 27
4	Rights and obligations under leases	No	No	Ind AS 116
5	Employers' rights and obligations under employee benefit plans	No	No	Ind AS 19
6	Rights and obligations under an insurance contract	No	No	Ind AS 104
7	Forward contract arising in case of business combination	No	No	Ind AS 104
8	Loan commitment other than covered under Ind AS 109 and Ind AS 32	No	No	Ind AS 37
9	Shared based payments	No	No	Ind AS 102
10	Reimbursement right in respect of provision	No	No	Ind AS 37
11	Rights and obligations under revenue for contracts with customers	No	No	Ind AS 115

Puttable instruments



Examples

Details	Conclusion
ABC Limited has 2 class of shares – Class A and Class B Shares. On liquidation class B shareholders are entitled to a pro rata share of the entity's residual asset maximum of INR 10 lakhs There is no limits to the rights of Class A shareholders to share in the residual assets on liquidation	a) Class B have cap limit and do not have pro rata share on residual value at the time of liquidation. Accordingly not an equity b) Class A no priority and it is subordinate to all other class of instruments. Accordingly it is equity
T limited 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 shareholders are not entitled to any voting rights. The holders of both class will receive equal shares in net assets upon liquidation	a) Neither of the class are equity b) Both do not have identical feature on voting rights c) Subordinate allocation becomes a challenge between as two as both gets equal share at the time of liquidation
S Limited has issued a class of puttable ordinary shares to T Limited. Besides the put option T limited is entitled to convert the class of shares into equity instruments of S limited whose number will vary as per market price	There is an obligation to settle the instrument in variable number of entity's own equity instruments This cannot qualify as equity
P limited has issued puttable ordinary shares to Q limited. Q limited has also entered into an asset management contract with P limited where by Q limited is entitled to 50% of the profit of P limited. Non commercial terms for similar contracts will entitle service providers to only 4-6% of net profits	a) Additional contract cash flow is linked to profit or loss of issuer b) Contractual terms are different from non instrument holder c) It has effect on substantially restricting return on puttable ordinary shares

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).

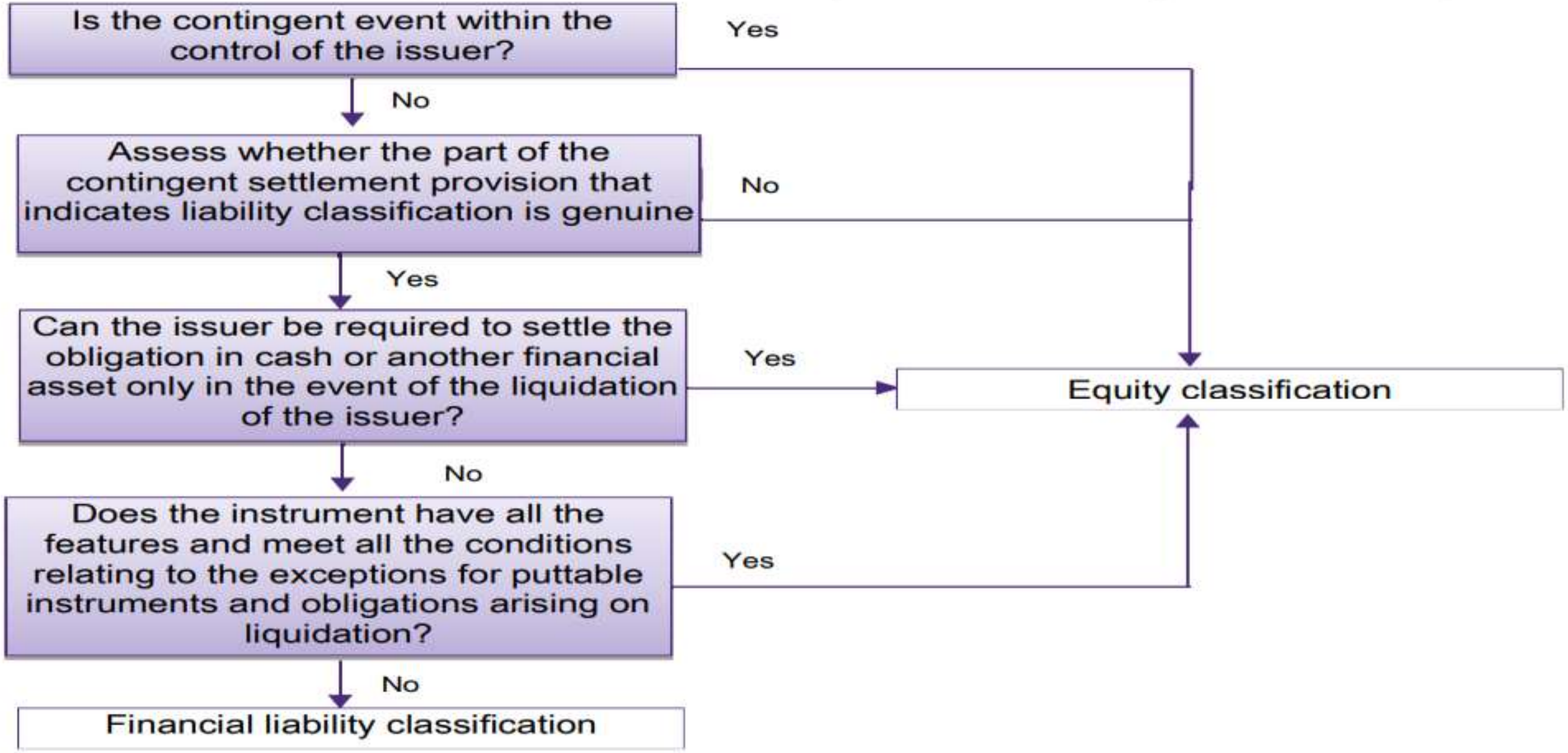
For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument that remain outstanding have all the features and meet all the conditions mentioned above, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the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

Contingent Settlement

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



Example

Example 4.1.3A: Contingent settlement provisions: change in accounting or tax law

Entity A issues preference shares bearing 5 percent non-cumulative dividends that are at the discretion of the issuer. The shares will be redeemed if the applicable taxation or accounting requirements were to change.

The contingent event of a change in taxation or accounting requirements is deemed to be genuine.

The requirement for redemption on change of taxation or accounting requirements represents a contingent settlement provision (i.e. it is an uncertain future event beyond the control of both the issuer and the holder of the instrument).

As the contingent event is genuine and can result in the issuer having to deliver cash or another financial asset at a time other than the Entity A's liquidation, the instrument is classified as a financial liability.

However, the 5 percent dividend is at the discretion of Entity A and, consequently, is equity of Entity A. Therefore, the preference share contain both debt and equity features, i.e. it is a compound instrument.

Example 4.1.3B: Contingent settlement provisions: initial public offering (1)

Entity B issues shares for CU1 million. Dividends are discretionary. Entity B must redeem the shares for par in the event of a flotation/initial public offering (IPO) of the entity. Entity B cannot guarantee a successful flotation/IPO, but it does have discretion as to whether or not to instigate proceedings to float or to seek an IPO. Given that Entity B can avoid redeeming the shares by avoiding the flotation/IPO, the instrument is classified as equity.

Example

Example 4.1.3C: Contingent settlement provisions: initial public offering (2)

Entity C issues shares for CU1 million. Entity C must redeem the shares at par in the event that Entity C is not subject to a successful flotation/Initial Public Offering (IPO) within five years from the date of issue of the shares. Entity C cannot guarantee a successful flotation/IPO, but it does have discretion as to whether or not to instigate proceedings to float or to seek an IPO.

Given that the contingent event (a successful flotation/IPO) is not in the control of Entity C, it is a contingent settlement provision. The contingent settlement provision is considered genuine, it is potentially payable other than at liquidation, and the shares do not meet the puttable exception in Ind AS 32. Because Entity C cannot avoid redeeming the shares for cash, the instrument contains an obligation to pay cash that creates a financial liability.

Example 4.1.3D: Contingent settlement provisions: change of control

Entity D issues preference shares for CU1 million. Entity D must redeem the preference shares at par in the event that control of Entity D changes. A change in control is defined in the terms of the preference shares as a change in ownership of at least 51 percent of the ordinary shares of Entity D.

Given that the contingent event (the sale of ordinary shares in Entity D by one set of shareholders to another) is not in the control of the Entity D, it is a contingent settlement provision. Because Entity D cannot avoid redeeming the preference shares, the instrument is classified as a financial liability.

Settlement through entity's own equity

- **<u>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</u>**. (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
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

Examples

Details	Conclusion
CBA Limited issues convertible debenture to RQP limited for a subscription amount of 100 crores. These debentures are convertible after 5 years into equity shares of CBA limited using pre determined formula	a) Contract uses equity only as a settlement mode instead of currency b) Variable number of instruments is used for settlement Contract is a liability
DF limited issues convertible debenture to JL limited for a subscription amount of 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of 10 each	a) Market changes do not change amount of cash or amount to be paid / received Conditions met are of equity
ST limited purchased an option from AT limited entitling the holder to subscribe to fixed number of equity shares at a fixed price of 50 per share at anytime during the period of 3 months. Holder pays an initial premium of rupees 2 per option	a) Settlement is for fixed amount and fixed number of shares So equity Assuming if exercise price is benchmarked to an index the written option will be classified as financial liability
WC Limited writes an option in favour of GT Limited wherein the holder can purchase issuers equity at prices that fluctuates in response to the share price of the issuer. As per the terms if share price is less than 50 option can be exercised at 40. If share price is equal to or more than 50 option can be exercised at 60	Contract is settled for variable amount and fixed number of instruments, it’s a financial liability

Examples

Details	Conclusion
A Limited enters into an arrangement with shareholders of T Limited wherein A Limited will purchase shares of T Limited in a share swap agreement against a variable amount of cash i.e. market value. The swap ratio agreed is 1:5	a) Settlement is through variable amount b) Settlement is for fixed instrument It has derivative liability or asset for both party & not equity
On Jan 1 NKT LTD, subscribes to convertible preference shares of VT Limited. The convertion ratio varies as a) Convertion upto March 31 1:1 b) Convertion upto June 30 is 1: 1.5 c) Convertion upto Dec 31 is 1:2	a) Convertion doesn't change corresponding to underlying variable b) It varies only as per passage of time Can be classified as equity
On Jan 1 HT limited subscribes to convertible pref shares of RT limited. The convertion ratio is 1:1. The terms of the instrument entitle HT limited to proportionately more equity shares of RT Limited in case of share split or bonus issue	a) Convertible pref shares can be classified as equity instruments in the books of issuer b) The variability of convertion ratio is to protect rights of holder c) Convertion is always expected to be in fixed ratio and hence the holder is exposed to change in equity value. The variability is to maintain exposure in line with other holders

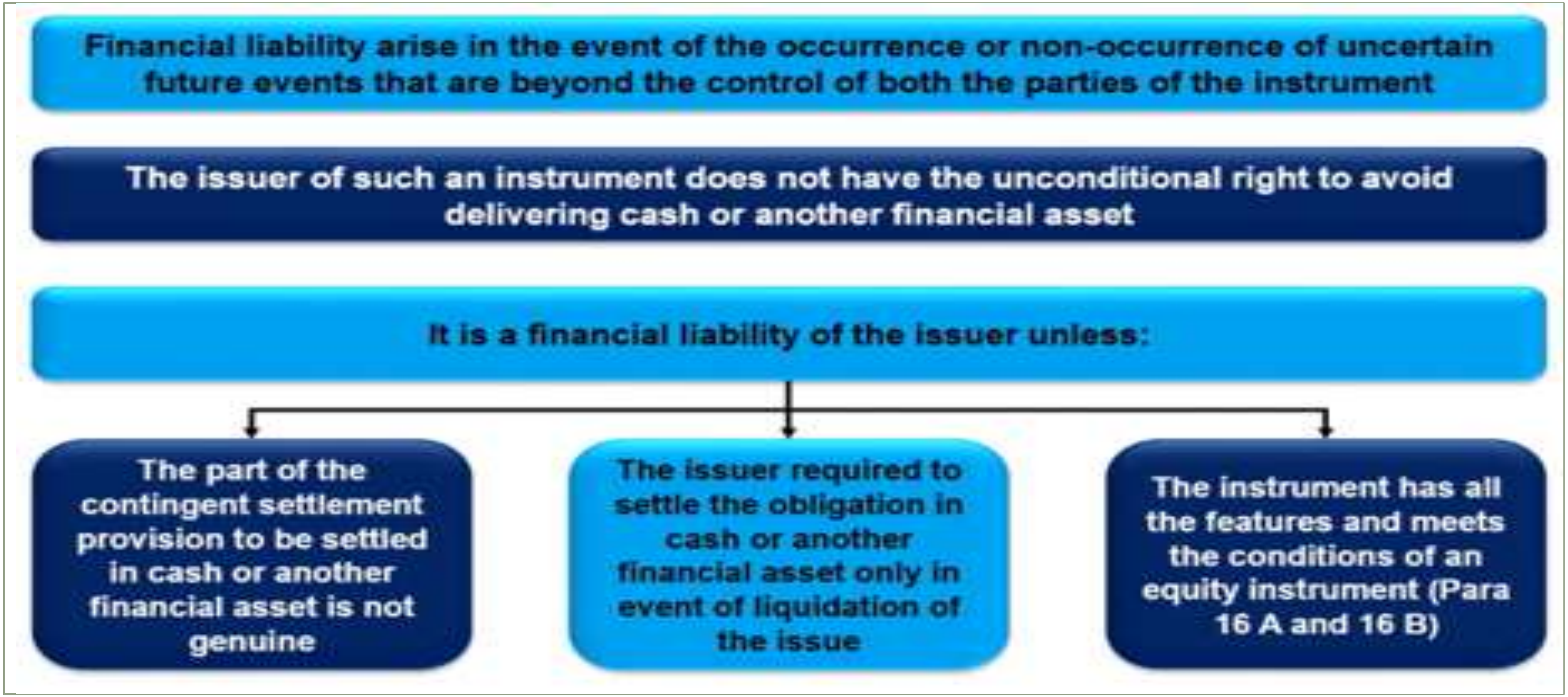
Examples

Details	Conclusion
On Jan 1 PG limited subscribes to convertible pref shares of BG limited at 100 per share. The convertion ratio is 10:1. On a fully diluted basis PG is entitled to 30% stake in BG If subsequent to issuance if BG limited issues any equity instruments at a price lower than 10 per share convertion ratio will be changed to compensate PG limited for dilution in its stake below the expected dilution of 10 per share	a) Classification will be as financial liability b) Variability in convertion ratio is not just protective right
On Jan 1 NG Limited subscribes to convertible pref shares to AG limited at 100 per share. On a fully diluted basis NG limited is entitled to 30% stake in AG limited The pref shares are convertible at fair value subject to NG limited stake not going below 15% and not going above 40%	a) Pref shares is not entitled to residual value of net assets then classify as financial liability b) If Instrument is convertible at the option of issuer then can be considered as equity

Examples

Details	Conclusion
On Jan 1 STAL Ltd subscribes to convertible pref shares of ATAL Limited. The convertion is as below a) 1:1 if another strategic investor invests at an enterprise value of USD 100mn b) 1.5:1 if another strategic investor invests at an enterprise value of USD 150mn c) 2:1 if another strategic investor invests at an enterprise value of USD 200mn d) 3:1 if none of the events occur in 3 years time	a) 4 events are interdependent b) Contract can be treated as single instrument for fixed to fixed test The test is failing as number of share is varying
On Jan 1 STAL Ltd subscribes to convertible pref shares of ATAL Limited. The convertion is as below a) 1:1 if another strategic investor invests in the issuer within 1 year b) 1.5:1 if prospectus filing is successfully completed within 2 years c) 2:1 if binding sale agreement for sale of majority stake is entered into within 3 years d) 3:1 if none of the events occur in 3 years time	a) Four events are discrete b) Arrangements can be considered as economically equivalent to 4 separate contracts c) Price per share and amount of shares to be issued is fixed in all 4 scenarios Fixed to fixed test is met so it is equity

Contingent Settlement Provision



Compound Financial Instruments

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"

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.

Compound Financial Instruments

Details	Conclusion
Redeemable pref shares with discretionary dividend X Ltd issues debenture to Y limited. These are redeemable at the end of 10 years. Interest of 15% p.a is payable at the discretion of the issuer. The rate is commensurate with credit risk profile	a) Mandatory redemption at future date for fixed amount & at fixed date b) Interest payable at the discretion of the issuer The first component is financial liability. The interest can be avoided by issuer so equity component. This instrument can be concluded to be a compound financial instrument
P co takes loan from Q co. The loan is perpetual at fixed interest of 8%p.a	a) Mandatory interest at fixed amount & date b) Principal is perpetual Interest is a liability and principal is an equity and this instrument has compound financial instrument
D Ltd issues pref shares to G Ltd. The holder has an option to convert these pref shares to equity instruments of the issuer anytime upto 10 years. If the option not exercised it is redeemed at the end of 10 years	a) Contractual obligation that is conditional on holder exercising its right to redeem b) Convertion option with holder First one is financial liability and convertion is equity This instrument is compound financial instrument

Compound Financial Instruments

Details	Conclusion
Borrowings from promoters at lower market rate	a) Present value the loan at market rate b) Difference will be accounted as additional paid in equity if its from shareholders c) Difference will be accounted as profit or loss if borrowed from third party
GST loan at NIL rate from government	a) Present value the loan at market rate b) Difference will be accounted as profit or loss if borrowed from third party
Preference shares with dividend rate different from market rate	a) Present value the pref share at market rate b) Difference will be accounted as additional paid in equity if its from shareholders c) Difference will be accounted as profit or loss if borrowed from third party

Split accounting

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.

- 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.

Split accounting

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.

Split accounting

Illustration 31: Optionally convertible redeemable preference shares (continued from Illustration 29)

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 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.

Split accounting

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.

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%.

Split accounting

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.

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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.

Reclassification

Reclassification subsequent to initial recognition may be required, if

- The entity amends the contractual terms
- The effective terms of the instrument have changed
- There is a relevant change in the composition of the entity

Reclassification of equity to financial liability

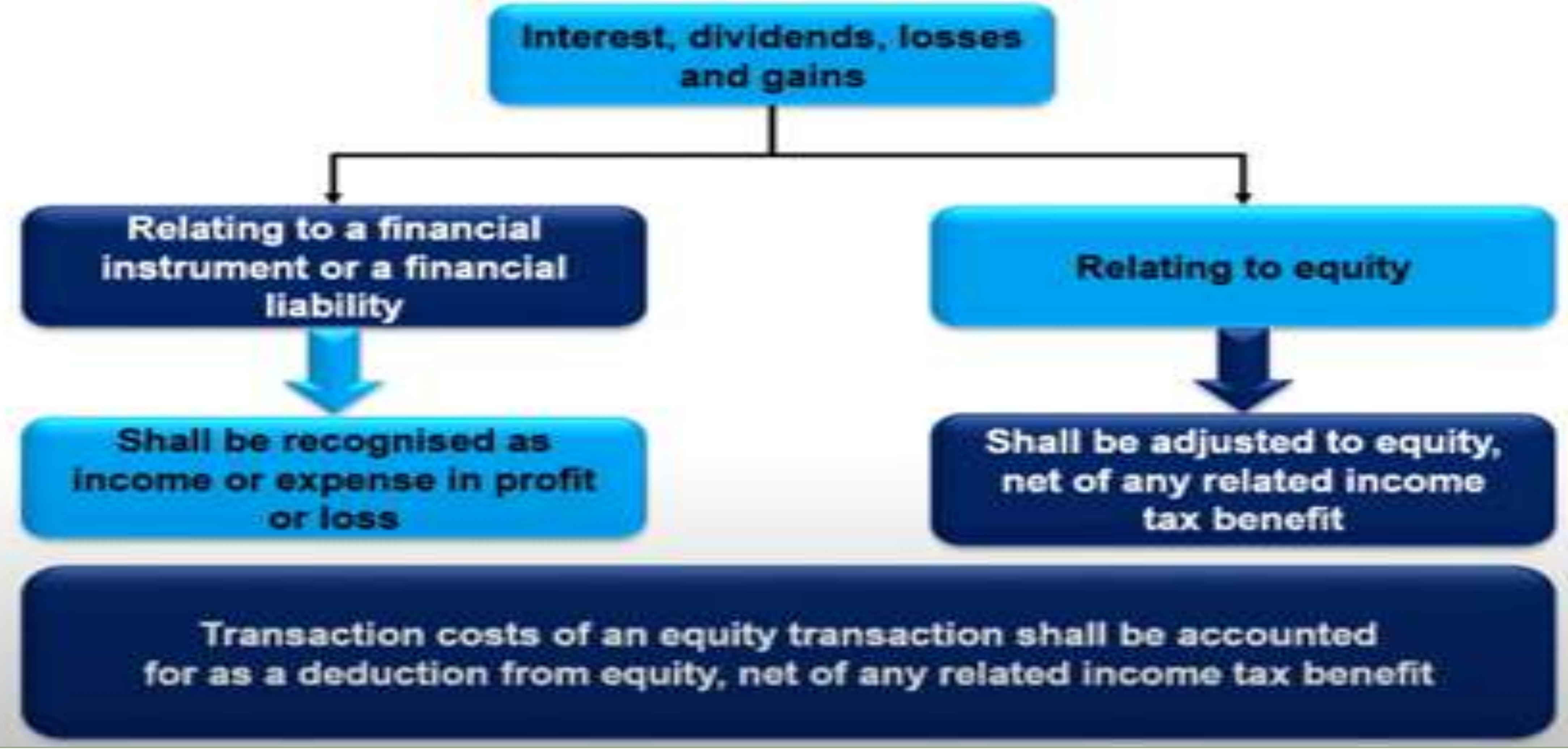
- De-recognise carrying amount of equity instrument;
- Recognise liability at fair value; and
- Recognise an adjustment in equity for the difference.

Reclassification of financial liability to equity

- Derecognise carrying amount of financial liability
- Recognise equity at the carrying value of the financial liability at the date of reclassification.
- Recognise the difference in profit or loss

Treasury Shares

Interest, Dividends, Losses and Gains



Examples

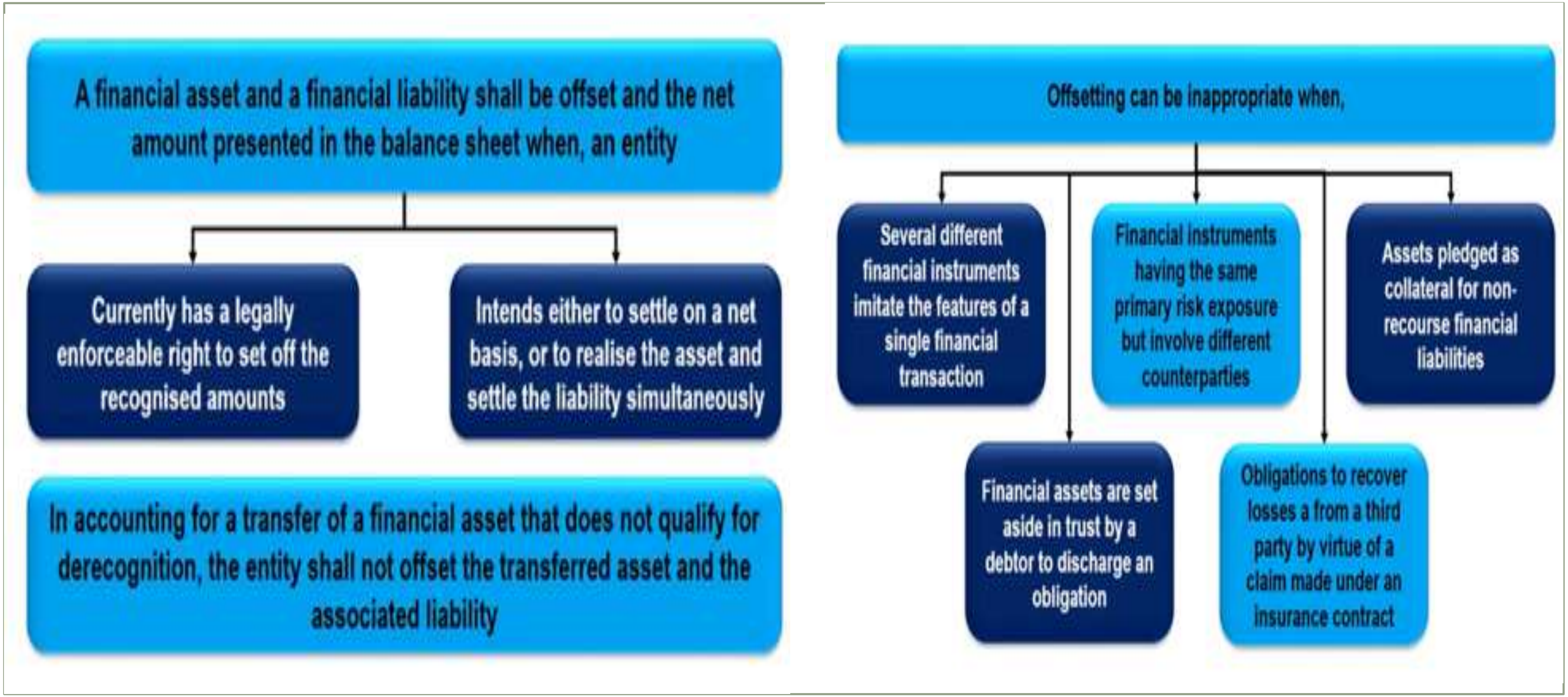
Example 6A: Effective interest rate and dividends for a compound instrument

Entity A issues a non-cumulative preference share that is mandatorily redeemable for cash of CU10 million in 10 years' time. During the life of the instrument, dividends are payable at the discretion of Entity A. The non-cumulative preference share is issued for CU8 million.

The non-cumulative redeemable preference share is a compound instrument. The liability component is determined as the present value of the eventual redemption amount of CU10 million discounted at the rate at which the entity could issue a similar instrument with a similar credit standing but without the feature of discretionary dividends during its life.

Assuming the liability component is equal to CU7.8 million, the residual amount of CU0.2 million will be treated as the equity component. The unwinding of the discount (between the redemption of CU10 million and its present value of CU7.8 million) on the liability component is accounted for using the effective interest method as an interest expense and reported in profit or loss. Any discretionary dividends actually declared and paid are treated as relating to the equity component and, therefore, are classified as an equity distribution.

Offsetting


A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, an entity
Currently has a legally enforceable right to set off the recognised amounts
Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously
In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability
Offsetting can be inappropriate when,
Several different financial instruments imitate the features of a single financial transaction
Financial instruments having the same primary risk exposure but involve different counterparties
Assets pledged as collateral for non-recourse financial liabilities
Financial assets are set aside in trust by a debtor to discharge an obligation
Obligations to recover losses a from a third party by virtue of a claim made under an insurance contract


Thank you